

The Spanish economy

In 2008, the slowdown that had already begun in the Spanish economy gave way to a sharp adjustment, with a decline in activity in the second half of the year, so that by end-2008 the economy was immersed in a deep recession. The factors that determined this performance have been described in detail in Chapters 1 and 2: domestic factors, linked in particular to the adjustment process in the real estate sector; and external factors, especially the international financial crisis and its implications for the world economy. GDP continued to grow in Spain in 2008 (1.2%), but it declined by 0.7% in year-on-year terms in 2008 Q4, and deteriorated further (-3%) in 2009 Q1. A breakdown of GDP in the period shows that it was marked by growing weakness of the main components of national demand, while net external demand made a positive contribution to GDP growth for the first time in several years, as exports recorded a good performance in the first half of the year and imports declined. The deterioration in the economic climate had a virulent impact on employment, which fell by 0.6% in the year as a whole but by more than 3% year-on-year in Q4. Moreover, there was no sign of any change in wage bargaining trends, with labour costs rising in excess of 5%. Despite this adverse economic climate, the labour force continued to grow at a strong pace (3%) and this, combined with job destruction, prompted a sharp increase in the unemployment rate, to 13.9% in 2008 Q4, almost 6 pp higher than in mid-2007. The authorities launched expansive fiscal measures in an endeavour to offset the economic weakness; together with the abrupt decline in activity, this brought the budget deficit to 3.8% of GDP, an increase of 6 pp on the 2007 budget surplus. The nation's net borrowing fell moderately in 2008, to 9.1% of GDP, although, as in the other indicators, the correction in the second half of the year was more significant, as imports declined rapidly and the price of oil returned to more moderate levels.

Energy prices were one of the key factors behind the sharp fluctuations in inflation over the year. After peaking in the summer of 2008, the CPI has decelerated very quickly, recording negative rates in the spring of 2009, partly as a result of these fluctuations in the price of oil but also due to the impact of the recession on price setting. As a result, the inflation differential with the euro area has been increasingly negative since December 2008.

1 Monetary and financial conditions

Monetary and financial conditions tightened in 2008, ...

... although the cost of debt fell towards the end of the year

The cost of issuing public debt declined and the effective exchange rate appreciated

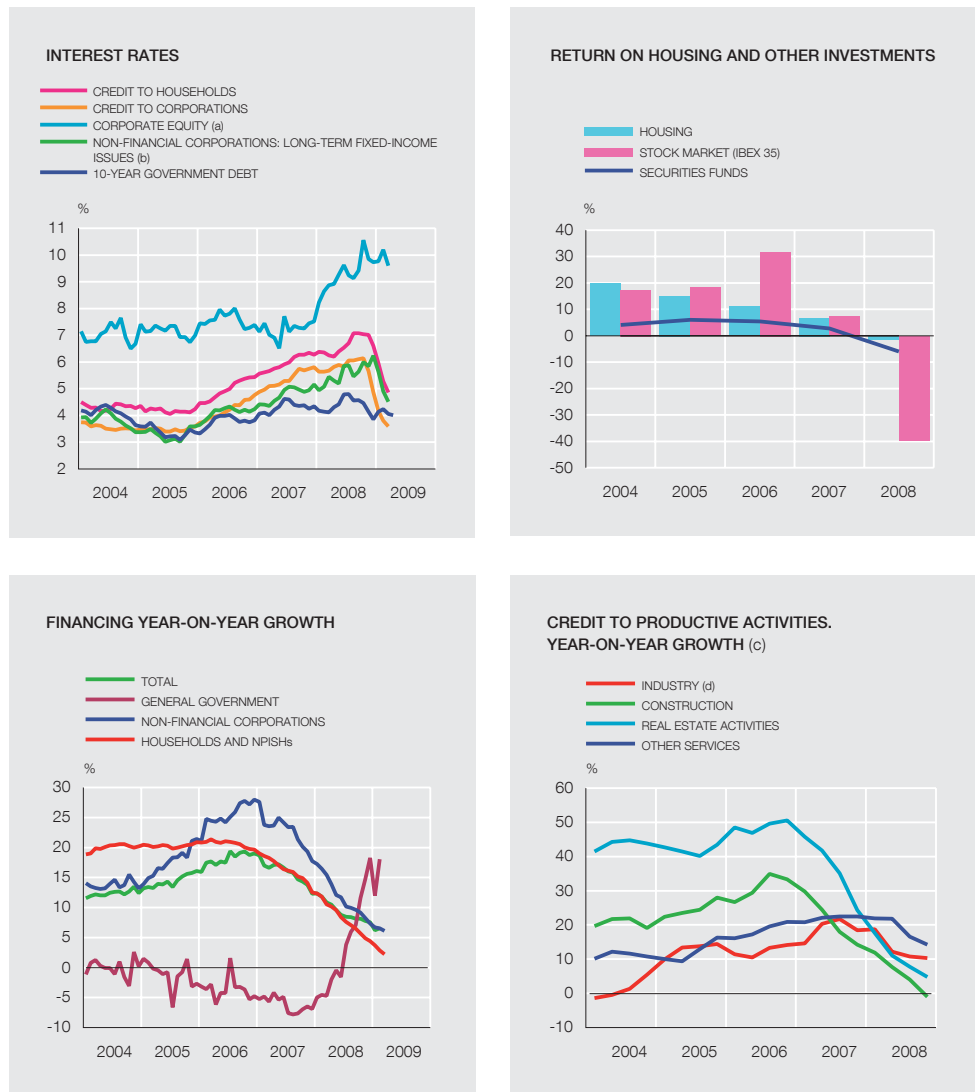
Household and corporate financing conditions continued to tighten in 2008 (see Chart 5.1). Interest rates on loans rose throughout the first nine months of the year, in line with the increase in interbank market yields that was basically due to the prevailing financial tension, and the cost of corporate debt and equity issues also rose, as risk premiums rebounded. In addition, credit standards applied by the banks became more restrictive.

Nevertheless, interbank market rates headed down during the closing months of the year, as official interest rates were cut, interest rate expectations were revised down and risk premiums declined, and this began to be passed through to new bank loans and, albeit more slowly, to the average cost of outstanding debt, given the high proportion of floating-rate loans.

The cost of issuing public debt also declined in the year as a whole. Thus, at end-2008 the yield on Spanish twelve-month Treasury bills stood at 2.1%, 1.9 pp less than a year earlier, while that on ten-year bonds stood at 3.9%, down from 4.3%. As in the case of most euro area sovereign debt, this decline was smaller than that in the German bund, so that the spread between them widened, to around 80 bp at December 2008 and more than 120 bp in February 2009. However this spread then narrowed again, to around 70 bp in early May. The effective nominal exchange rate appreciated by 2.7 pp in cumulative annual terms, having a slightly contractive effect on monetary conditions.

FINANCING OF RESIDENT NON-FINANCIAL SECTORS AND ASSET PRICES

CHART 5.1



SOURCES: Datastream, MSCI Blue Book and Banco de España.

- a. The cost of equity is based on the three-stage Gordon dividend discount model.
- b. The interest rate on long-term fixed income is calculated as the sum of the 5-year euro swap rate and the weighted average of the credit risk insurance premia of Spanish non-financial corporations at that same term.
- c. Securitisation is included in the total series, but not in the different sectors, since there is no information to assign it to the latter.
- d. Excluding construction.

Net household wealth declined in real terms

The international financial crisis had an adverse impact on the value of households' financial and real estate assets: the IBEX 35 closed 2008 down almost 40% and house prices fell by 3.4% in real terms in the year. Thus, net household wealth declined, with the consequent adverse impact on consumption and residential investment. Stock market losses also discouraged business investment.

Household and corporate indebtedness ceased to grow, but the debt burden rose

Tightening credit conditions, along with declining household confidence and diminishing wealth, meant that the rate of growth of household liabilities continued to slow (see Chart 5.1). In the year as a whole, the rate of growth of borrowing fell by 8 pp year-on-year, down to 4% at end-2008. Accordingly, the debt ratio fell slightly, but as yet with no decline in the associated debt burden, due to the increase in the average cost of outstanding debt.

The rate of growth of corporate financing fell more sharply (by more than 10 pp), to around 7% at year-end. The rate of growth of credit, which is the main component, moderated in all areas of activity, but most especially in real estate services and construction (where growth rates fell by some 20 pp and 15 pp, respectively). The corporate debt ratio remained virtually unchanged, as the increase in debt was similar to the increase in revenue, but this, together with the rise in the average cost of borrowing, drove up the debt burden ratio once again. Lastly, as a consequence of the worsening of the fiscal balance of the general government, borrowing by this sector rose significantly in 2008, posting year-on-year growth of almost 16% at year-end, in contrast to the negative rate of change seen a year earlier.

2 Economic policies

2.1 FISCAL POLICY

An expansive fiscal policy was designed for 2008, ahead of an expected slowdown in growth

In the wake of a fiscal surplus amounting to 2.2% of GDP at end-2007, and ahead of an expected gradual slowdown in activity, the fiscal policy envisaged in the State budget for 2008 included hardly any significant regulatory changes. Nevertheless, revenue would be affected by a number of measures taken in previous years, including, inter alia, the residual impact on tax payable of the reduction in personal income tax and the corporate income tax rate cuts. On the spending side, the growth rate budgeted for non-financial State expenditure in 2008 was 9%, if compared with the outturn for 2007, significantly higher than the nominal GDP growth forecast. The regional (autonomous) governments' budgets were drawn up along similar lines, projecting an increase in non-financial expenditure in excess of 8% when compared with the initial figures for 2007. So all in all, an expansionary fiscal policy.

As economic slowdown accelerated, new fiscal measures were approved in the year, leading to greater fiscal expansion, ...

As economic slowdown accelerated, new fiscal measures were approved in the year. Together with the budget measures, these represented a strong fiscal impulse and a significant budget cost, estimated as 1.6 pp of GDP (see Table 5.1 which lists and quantifies the stimulus measures adopted in 2008 and 2009, distinguishing between permanent and temporary measures; see also Box 5.1). The key new measure, in terms of its impact on revenue, was the personal income tax rebate of up to €400, via lower withholdings on earned income, which was approved in April 2008 and came into force in the year. In addition, in November two new funds were created, endowed with total resources amounting to 1% of GDP, to foment local investment and investment in strategic sectors in 2009 (the State Fund for Local Investment and the Special State Fund to Invigorate the Economy and Employment). The impact on activity of the measures introduced in 2008 may have been lessened by the climate of uncertainty, the situation of private-sector saving at the start of the year and the decline in expenditure.

... a sharp decline in revenue and a significant increase in unemployment benefits

The economic slowdown, and in particular the deceleration in national demand, led to a sharp decline in tax revenue, confirming that the increase in revenue seen in the expansionary phase included a significant temporary component, linked above all to the strength of the real estate sector. Accordingly, the sharp adjustment in this sector quickly passed through to revenue. At the same time, the automatic stabilisers were activated, prompting a significant increase in unemployment benefits, which rose by 0.4 pp as a percentage of GDP.

As a result, by end-2008 the surplus recorded in 2007 had been transformed into a sizeable budget deficit

As the extraordinary revenue linked to the property boom of recent years disappeared, and in light of the automatic stabilisers' responsiveness to the business cycle, the new measures introduced and the continued dynamism of public expenditure, the budgetary situation deteriorated significantly. Thus, by end-2008, the surplus recorded in 2007 had been transformed into a general government deficit of 3.8% of GDP (see Box 5.1).

By sub-sector, only Social Security continued to post a surplus (0.8% of GDP), although short of that seen in 2007. Central government (the State and its autonomous bodies) recorded a deficit of 2.7% of GDP, as opposed to a surplus of 1.3% of GDP in 2007, while territorial government deficits widened somewhat, to 1.4% of GDP in the case of the regional (autonomous) governments, and

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FISCAL MEASURES	2008	2009	2010
TOTAL IMPACT (I - II)	-18,121	-22,577	-1,075
I Non-financial revenue	-17,940	-14,377	-75
I.a PERMANENT IMPACT	-14,640	-8,002	
2% deflation of tax rates, personal and family allowances and earned income allowance under personal income tax	-1,030		
Expected impact of 2007 personal income tax reform	-2,400		
Tax relief under personal income tax for birth or adoption of children	-1,090		
€400 tax rebate on earned income under personal income tax	-4,100	-1,900	
Tax relief for tenants under personal income tax		-350	
Expected impact of corporate income tax reform (2007-2008)	-5,520	-3,452	
Freeze on excise duties	-500		
Elimination of wealth tax		-2,300	
I.b TEMPORARY IMPACT	-3,300	-6,375	-75
Inclusion of tax credit on home ownership (main residence) in calculation of personal income tax withholdings		-1,200	
Extension of period for realisation of home-purchase savings accounts		-15	-15
Corporate income tax: income delayed due to lack of application of new chart of accounts in prepayments in 2008		2,600	
Tax exemption for interest on public debt held by non-residents under corporate income tax	-500	-500	
Incentives for temporary hires		-1,200	
Consolidation of VAT returns in corporate groups	-2,800		
Monthly VAT refunds brought forward		-6,000	
Temporary partial moratorium on mortgage repayments		-60	-60
Extension of two-year period for sale of main residence for purposes of exemption due to reinvestment		NA	NA
Unrestricted depreciation or amortisation of new assets under corporate income tax		NA	NA
II Non-financial expenses	181	8,200	1,000
II.a PERMANENT IMPACT	181	-1,500	-1,000
Reduction in expenses (a)	-20	-1,500	-1,000
Extraordinary vocational guidance, training and integration plan	201		
II.b TEMPORARY IMPACT		9,700	2,000
Unemployment benefits (b)		700	
State Fund for Local Investment		6,000	2,000
Special State Fund to invigorate the Economy and Employment		3,000	
III With impact on public debt (no impact on balance)	9,339	20,661	
Fund for the Acquisition of Financial Assets (maximum €30 bn)	9,339	20,661	
OTHER MEASURES	Entry into force	Funding	
I ICO (Official Credit Institute) credit facilities			
Total funding			49,100
ICO credit facility to guarantee local corporations' debts to firms and the self-employed	26.04.2009		3,000
ICO liquidity facility for SMEs and the self-employed (c)	23.12.2008		10,000
ICO liquidity facility for medium-sized companies (c) (d)	March 2009		6,000
ICO corporate support facilities 2009	2009		10,900
New ICO moratorium facility for SMEs (e)	2009		
ICO-PROINMED credit facility (investment projects for medium-sized companies)	Expected March 2009		3,000
Extension of Treasury FTPYME facility (securitisation SPEs for SMEs)	2009-2010		6,000
ICO housing credit facility: loans for completed housing used for rental housing (main residence)	2009		3,000
Extension of ICO guarantee for asset-backed securities linked to government-subsidised housing (FTVPO facility)	2009		5,000
Plan Renove Turismo (tourism industry modernisation programme)	2009		1,000
Plan VIVE (vehicle renewal programme)	2008-2011		1,200
II Other support measures			
State subsidies for car purchases (€500 per unit)	2009-2010		100
Extension of mortgage repayment periods at no cost for two years	22.04.2008		
Special conditions for deferral of payment of Social Security contributions	2009		

NA: No quantitative estimate is available.

- a. The estimate does not include the impact of the reductions in headcount or executive pay.
b. The estimate does not include the impact of the new treatment of redundancy programmes.
c. The ICO contributes 50% and the banks the other 50%.
d. Supplementary to the ICO Liquidity facility, but for larger corporations.
e. Amount deferred: €5 bn.

One of the key features of the development of the Spanish economy in 2008 was the extent of the budgetary deterioration, as by end-2008 the general government surplus of 2.2% of GDP in 2007 had been transformed into a deficit of 3.8%.

This deterioration in public finances (6 pp of GDP) in 2008 was primarily due to three factors: cyclical deterioration, the effects of the discretionary fiscal measures applied, and the disappearance of a certain amount of temporary revenue associated with the developments on the real estate and financial markets (see accompanying table). First, the cyclical deterioration, which drove down the general government balance by some 0.7 pp of GDP in comparison with the previous year, largely due to the increase in unemployment benefits as the jobless total rose. Second, the discretionary measures, which had a negative impact of slightly more than 1.5 pp of GDP, and in particular the new package of measures announced in April 2008 that included, *inter alia*, a cost of 0.5 pp of GDP in the form of the €400 personal income tax rebate. Moreover, the impact of other discretionary measures that were known at the beginning of 2008 proved greater than was initially expected. Thus, the impact of the CUNA Programme and of the personal and corporate income tax reforms warranted a decline in revenue of almost 0.8 pp of GDP in 2008, while the impact of the new VAT system on consolidated groups also detracted from revenue to the tune of some 0.3 pp of GDP.

The rest of the budgetary deterioration, more than 3.5 pp of GDP, is chiefly due to two factors. First, the tax revenue losses over and above those warranted by the development of the theoretical bases used to predict the behaviour of the different tax headings and their respective elasticities. These revenue deviations are thought to be largely connected to the decline in the extraordinary revenue that was obtained during the economic growth phase from the boom on the real estate and financial markets. According to a Banco de España

study,¹ this extraordinary revenue accounted for more than 2 pp of GDP in cumulative terms up to 2007. And second, the growth in public expenditure that is not directly linked to economic performance, which is estimated to have risen substantially above trend GDP. Thus the ratio of primary expenditure adjusted for cyclical effects (the latter, basically connected to unemployment benefits) to trend GDP would have risen by approximately 1.5 pp in 2008, with a significant contribution from compensation per employee.

Public finances will foreseeably deteriorate again in 2009; according to the latest Banco de España projections report, the deficit forecast for 2009 will amount to 8.3% of GDP, an increase of 4.5 pp on 2008, fundamentally as a result of the increase of 4.3 pp in the expenditure ratio.

There are three key factors behind the expected growth in the budget deficit in 2009: the marked cyclical deterioration, the impact of the discretionary measures, and the change in trend in public debt servicing payments. First, the macroeconomic climate is expected to worsen significantly in 2009, prompting further deterioration of 2.5 pp of GDP in the general government balance connected to the economic cycle. It should be noted, in this respect, that when tax figures are analysed in terms of ratios to GDP, the automatic stabilisers have most impact on public expenditure, as government receipts as a whole have elasticity close to one relative to GDP. Specifically, more than 0.5 pp of the increase in the expenditure ratio are directly due to unemployment benefits. Second, the bundle of discretionary measures with effect in 2009 will have an adverse impact on the

1. F. de Castro, A. Estrada, P. Hernández de Cos and F. Martí (2008), "Una aproximación al componente transitorio del saldo público en España", *Boletín Económico*, June, Banco de España, pp. 71-81. And on the same lines, the European Commission Economic Paper by C. Martínez-Mongay, L. A. Maza and J. Yáñez (2007), "Asset Booms and Tax Receipts: The Case of Spain 1995-2006", *European Economy Economic Papers*, nº 293.

FACTORS BEHIND THE CHANGES IN THE GENERAL GOVERNMENT BALANCE

Changes in variables over the previous year, expressed as a % of GDP

	2008	2009
Change in the general government balance	-6.0	-4.5
<i>Due to the change in the cyclical position (a)</i>	-0.7	-2.5
<i>Due to the impact of the discretionary measures</i>	-1.6	-1.8
<i>Due to debt servicing</i>	0.1	-0.2
<i>Remainder</i>	-3.8	-0.0
Change in total resources	-4.4	-0.2
Change in total uses	1.6	4.3

SOURCE: Banco de España.

a. The cyclical impact on the budgetary balance is obtained by applying an elasticity of 0.43 to the output gap calculated using the Phillips curve.

deficit, estimated as 1.8 pp of GDP, considering that certain temporary measures that had an impact in 2008 should be reversed in 2009. The measures for 2009 include, in particular, earlier-than-usual VAT refunds, which will add 0.6 pp of GDP to the deficit, the elimination of wealth tax, with a cost of approximately 0.2 pp of GDP, and approval of the State Fund for Local Investment and the Special State Fund to Invigorate the Economy and Employment, which represent 0.6 pp and 0.3 pp of GDP, respectively. And third, debt serv-

icing payments are expected to add to budgetary deterioration by 0.2 pp of GDP more than in 2008, as public debt expands.

In short, all the above shows that, although part of the deterioration in public finances seen in 2008 and forecast for 2009 is due to cyclical deterioration, much of this deterioration is structural and that, in consequence, a return to healthier public finances will necessarily require considerable budgetary adjustment.

0.4% of GDP in that of local governments. Thus, after declining as a percentage of GDP since 1997, public debt rose by 3.3 pp on a year earlier, standing at 39.4% of GDP at end-2008.

By component, fiscal pressure declined considerably ...

One of the main reasons behind the deterioration in public finances in 2008 is the decrease of slightly more than 4 pp in the tax burden (tax revenue relative to GDP), which contrasts with the increase of more than 5 pp in this variable between 1995 and 2007 (see Table 5.2). Revenue from direct and indirect taxes declined, while social security contributions remained unchanged as a percentage of GDP. Against the backdrop of contraction in activity, the decline in revenue was concentrated on taxes linked to corporate profits, the real estate sector and consumption: specifically, corporate income tax revenue fell by almost 2 pp of GDP, VAT revenue by almost 1 pp and revenue from stamp and registration duties by 0.7 pp of GDP. By contrast, personal income tax revenue fell only marginally, despite the impact of the new tax rebate and the employment adjustment, sustained by tax withholdings on capital gains and, to a lesser extent, on earned income which continued to post positive rates of change due to the strong growth in wages.

... and public spending grew as a percentage of GDP, driven by government consumption and social benefits

Public spending rose by 1.7 pp as a percentage of GDP to 41%. This growth was due almost exclusively to primary current spending, in a setting in which interest payments held steady as a percentage of GDP for the third consecutive year. As in previous years, final public consumption grew significantly. In this respect, the high inertia in health and education spending, which represent a very significant proportion of public consumption, is particularly noteworthy, as is the growth in the public-sector wage bill which, on the back of high wage drift in recent years, amounted to 9% in 2008. Social benefits rose by 0.7 pp as a percentage of GDP, primarily as a result of the growing volume of unemployment benefits, but also due to the increase in contributory pensions associated with the acceleration in the average number of pensions and the new benefits for birth and adoption of children. Lastly, capital expenditure decelerated in 2008, as the rate of growth of investment fell to 2.4% (from 10.3% in 2007), although it continued to represent 3.8% of GDP, in line with the pattern seen in previous electoral cycles of more moderate capital expenditure growth in post-election years.

The introduction of new economic stimulus measures and the impact of the unfavourable macroeconomic climate point to a budget deficit in excess of 8% in 2009 and 2010, ...

Fiscal policy in 2009 will remain clearly expansionary, as a result of the measures that have come into force in the year, in particular the State Fund for Local Investment, mentioned earlier, and the decision to bring forward monthly VAT refunds. These are mainly temporary measures, directed at specific sectors and targets, so they may have a more expansionary impact on activity. On Banco de España estimates, the State Fund for Local Investment could add 0.3 pp to GDP growth on average in 2009 and 2010.

All in all, considering the high budget deficit recorded in 2008, the various steps taken and the contraction in activity could lead to a budget deficit in excess of 8% in 2009 and 2010. This would also entail a rapid increase in the public debt to GDP ratio, which could approach 60% in 2010.

% of GDP	2003	2004	2005	2006	2007	2008
1 NON-FINANCIAL RESOURCES	38.5	38.9	39.8	40.9	41.5	37.1
Current resources	37.8	38.1	39.1	40.2	41.0	37.0
— Taxes on products and imports	11.5	11.9	12.2	12.4	11.7	9.8
— Taxes on income and wealth	10.1	10.2	10.9	11.7	12.9	10.7
— Social contributions	13.0	13.0	12.9	12.9	13.0	13.0
— Other current resources (a)	3.3	3.1	3.0	3.2	3.4	3.4
Capital resources	0.7	0.9	0.8	0.7	0.4	0.1
2 NON-FINANCIAL USES (b)	38.7	39.3	38.9	38.9	39.3	41.0
Current uses (b)	33.9	34.0	34.0	33.8	34.0	35.7
— Final consumption	17.4	17.8	18.0	18.1	18.3	19.1
— Social benefits other than social transfers in kind	11.7	11.7	11.6	11.5	11.6	12.3
— Subsidies	1.0	1.0	1.0	1.0	1.1	1.1
— Interest (b)	2.3	2.0	1.8	1.6	1.6	1.6
— Other transfers	1.5	1.5	1.5	1.6	1.5	1.6
Capital uses	4.8	5.2	4.9	5.1	5.2	5.3
— Gross capital formation	3.6	3.4	3.6	3.7	3.8	3.8
— Other capital uses (c)	1.3	1.9	1.4	1.4	1.4	1.5
3 NET LENDING (+) OR NET BORROWING (-) (b) (3=1-2)	-0.2	-0.3	1.0	2.0	2.2	-3.8
MEMORANDUM ITEM:						
Primary surplus	2.1	1.7	2.8	3.7	3.8	-2.3
Gross debt (b)	48.7	46.2	43.0	39.6	36.2	39.5

SOURCES: INE, Ministerio de Economía y Hacienda and Banco de España.

a. Includes gross operating surplus.

b. According to the Excessive Deficit Procedure methodology.

c. Includes net acquisitions of non-financial non-produced assets.

... which will necessitate development of a consolidation strategy in the medium-term

In terms of fiscal policy, all this severely constrains the room for manoeuvre, making a return to budgetary stability a key priority in the medium term. In particular, it is vital that the deterioration of the fiscal position is not seen as a persistent deviation, as risk premiums on government debt seem to have become more sensitive to the perceived sustainability of public finances, inter alia. Although, in relative terms, government debt is still lower than the average in the euro area, the speed of its growth could make a subsequent reversal more difficult and could drive up borrowing costs. Moreover, it is essential that government debt ratios remain moderate, to provide favourable conditions for the future increase in spending on pensions.

The consolidation strategy must be consistent with the commitments acquired within the framework of the European Union

In 2008, Spain's central and territorial (regional and local) governments ran budget deficits in excess of the limits established in the budgetary stability regulations. In April 2009, the European Council determined that Spain was running an excessive deficit¹ and recommended that this situation be corrected by 2012 at the latest, requiring annual average fiscal adjustment of at least 1.25% of GDP, to start in 2010. In the end, the Council set 27 October 2009 as a deadline for the corrective action to be taken.

1. Considering that the 2008 budget deficit had exceeded the 3% reference value set in the Stability and Growth Pact (SGP), and that this situation could not be qualified as temporary or as having been reached in exceptional circumstances, both factors that could have prevented the launch of the Excessive Deficit Procedure (EDP) under the SGP. In effect, the Council considered that the economic circumstances of 2008 could not be qualified as exceptional, as both the estimated output gap and real GDP growth for that year were positive. Moreover, the divergence from the deficit target could not be considered temporary, as the fiscal projections presented by the European Commission and contained in the Spanish Stability Programme in January 2009 envisaged that the budget deficit would exceed 3% in 2009 and in 2010.

2.2 OTHER ECONOMIC POLICIES

The emergence and the scale of the economic crisis conditioned all other economic policies

Thus the Official Credit Institute extended and launched new credit lines for households and firms ...

... and various measures were adopted in connection with housing and modernisation of the tourist industry

By contrast, there was little significant change in the labour framework

The reforms in the goods and services markets focused on promoting transposition of the Services Directive

The main aim behind all other economic policies was to alleviate the impact of the economic crisis. A first set of measures was designed to help certain sectors and agents gain access to credit, while others aimed to support activity in the productive sectors most affected by the collapse in demand, such as residential building, tourism and, in 2009, the automobile industry.

Through the ICO (Official Credit Institute) the government launched a series of extraordinary credit facilities for the groups most affected by the liquidity problems on the financial markets. As is customary, these measures were instrumented in collaboration with the private banking sector, which selected the borrowers and assumed the majority of the default risk. In the case of households, a credit facility was created to allow mortgage holders who had lost their jobs to defer part of their mortgage repayments, while for SMEs funds were earmarked to finance cash flows. The bulk of these measures will come into force in 2009 (see Table 5.1), meaning that so far the impact has been limited.

In January 2008, the 2005-2008 Housing Plan was amended and, in December 2008, the new 2009-2012 National Housing Plan was approved, in an endeavour to adapt to the sharp slowdown in the sector. To this end, more emphasis was placed on rental housing, with the introduction, *inter alia*, of rentals with purchase options and enhanced tax treatment for home refurbishment. The Plan also calls for a large volume of subsidised housing to be built in coming years. In the case of the tourism industry, the ICO launched a €1 billion credit facility to help the industry modernise its infrastructure. Lastly, in 2009 a comprehensive plan for the automobile industry was approved, affecting both the demand and the supply side; this was subsequently extended to include direct subsidies for new car purchases.

On the labour market, a new Inter-Confederal Collective Bargaining Agreement (AINC) was signed in 2008, similar to those signed in previous years, and the minimum wage rose by 5.3% to €600 per month. In any case, wages were marked by activation of the indexation clauses which, together with the rebound in wage rates, helped drive wages up by more than 5%, the highest rate of growth in the last 15 years, despite the considerable cyclical weakness.

Two of the fundamental features of the present collective bargaining system, namely its high nominal inertia and its lack of responsiveness to changes in the economy's cyclical situation, together with the high degree of labour market segmentation, made this market more vulnerable to the decline in economic activity, prompting a sharp rise in unemployment in the second half of 2008 which has continued in the opening months of 2009. In this respect, reform of the wage-setting mechanism, establishing a closer link between wages and productivity and, in general, between wage rises and the position of specific firms or industries, would present a more appropriate basis for economic recovery. In addition, in the short term, a strong commitment to wage moderation by the social agents would help contain job losses (see Chapters 1 and 2 above).

On the goods and services markets, the focus was on making progress in the transposition of the Services Directive, culminating in March of this year when the legislation required to start this process was approved. This legislation establishes free access to and exercise of service activities, with no need for prior authorisation, it removes the barriers to the free development of services by providers without an establishment in Spanish territory and it simplifies the administrative procedures. These aspects of the draft legislation are positive and should help liberalise the services sector and lessen the administrative burden for firms, in line with the government's commitment to reduce this burden by 30% by 2012. Once it has been passed by Parliament, the success of the reform will depend, however, on its correct implementation

(in particular in key sectors such as professional services and retail trade) and on strict control of the exceptions permitted by law, nationally and at regional (autonomous) government level.

Investment in R&D rose slightly, but there were no improvements in human capital indicators

In the case of technology, in 2008 the public sector maintained the level of investment in R&D seen in previous years. Several measures were announced, including reorganisation of the public research bodies, entry into force of the Avanza2 Plan, which aims to give a new boost to the introduction of information and communication technologies (ICT), and a new Science and Technology Law to establish the guidelines for future government policy in this area. The Ingenio Programme continued on the scale of previous years, although investment in R&D grew by barely 0.1 pp in 2007, to 1.3% of GDP, still far from the levels seen in the main developed economies, due to lower business investment (which fell, once again, as a percentage of total R&D spend to 45.5%). There were no signs of significant progress in human capital indicators; in fact, in some indicators, such as the early school leaving rate, there was a step backwards.

The severity of the crisis reveals the need for further structural reforms

In short, the severity of the crisis, which in 2008 prompted, for the first time since 1993, a slight decrease in income per capita, reveals the need, beyond the short-term measures, for structural reforms in the product and factor markets and for improvements in human and technological capital stock, to ensure that the present adverse economic situation does not detract from future economic growth potential.

3 Demand

3.1 NATIONAL DEMAND

Weakness in national demand, and especially in household spending, heightened in 2008

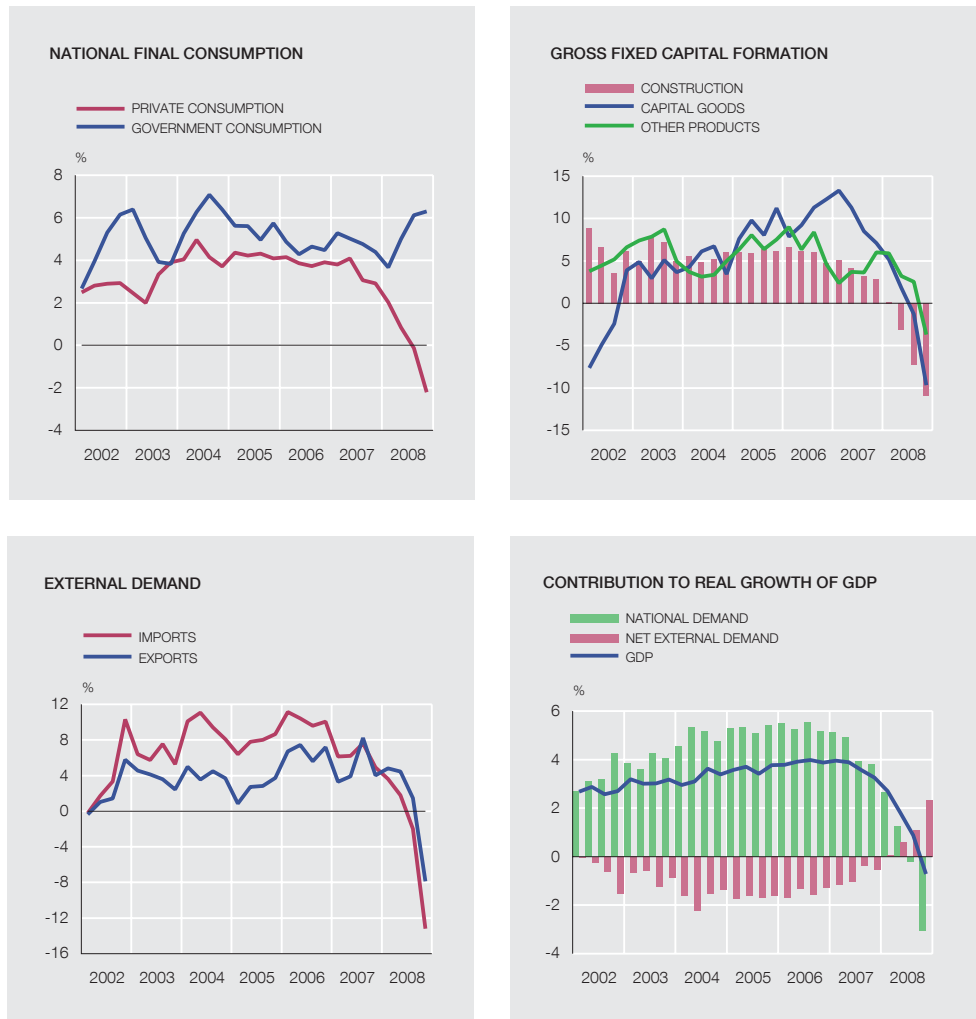
The slowdown in national demand heightened as the year progressed: all private spending components lost momentum, but especially household spending, as both private consumption and residential investment fell sharply (see Chart 5.2). Private productive investment also moderated significantly, most particularly in 2008 Q4, and in fact only government spending on current goods and services posted higher growth than a year earlier. The persistent financial tension, which heightened in the last four months of the year, was a major contributing factor to this weak private demand, and this on top of the adjustment that had already begun in the Spanish economy in 2007. The financial crisis affected national demand through its adverse impact on credit availability and credit conditions and on agents' confidence, which was also hit by the speed and extent of the deterioration in the labour market. Job losses, along with their direct impact on income, were probably the key factor behind the decrease in spending, especially in household spending.

Private consumption was the key contributing factor to the slowdown in GDP in 2008, with durable goods recording the sharpest contraction

Growth in private consumption stagnated in 2008: the year began with year-on-year growth of 2%, but by Q4 this had gradually been transformed into a negative rate of change of -2.2%. All consumer spending components showed signs of lost momentum, but most particularly durable goods purchases, affected not only by the above-mentioned causes but also by the decline in other factors that had boosted demand for these goods in the past, such as the property boom and the number of immigrants becoming established in Spain (see Table 5.3). Car purchases by individuals fell by 30% in the year, with the sharpest rates of decline seen after the summer (-46% year-on-year in 2008 Q4, followed by -37% in 2009 Q1). The rate of growth of purchases of non-durable goods and services proved more resilient, although it also declined significantly on previous years.

Real household income grew at a relatively strong pace in 2008, ...

Despite the progressive deterioration in the macroeconomic climate, real disposable income rose by 3.8%, due, above all, to the considerable expansionary effect of the public sector support measures on household finances (see Chart 5.3). By contrast, the rebound in compensation per employee did not lead to an increase in the wage bill, given the extent of job losses. Net interest payments continued to detract from household income, although less so than in the



SOURCE: INE.

a. National Accounts, base 2000. Year-on-year rates of change based on seasonally-adjusted series of volume indices.

previous year, an effect that was particularly noticeable towards the end of 2008 and in the opening months of 2009, following the extensive interest rate cuts on the money markets. Lastly, the significant rise in the price of oil up to the summer of 2008, and its impact on consumer prices, eroded the purchasing power of households' current revenue and this also drove down confidence. Nevertheless, the inflation outlook changed dramatically as from July, when the rates of change of consumer prices began to gradually decline, and by March 2009 prices were falling in year-on-year terms, facilitating some recovery in households' purchasing power.

... but tighter credit conditions, diminishing household wealth and the sharp rise in unemployment took their toll on household confidence, prompting a decline in consumption ...

Although income growth was higher than a year earlier, all other consumption determinants performed less well than in 2007, helping to explain the sharp adjustment in household spending in 2008. Thus, real interest rates (proxied ex-post, deflating interest rates with developments in consumer prices) rose, and all other credit conditions tightened. At the same time, household financial wealth diminished considerably, as the stock markets and residential property values fell. Rising unemployment and, towards the end of the year, the heightened financial crisis, added to these factors, driving household confidence down to all-time lows. The fall-off in consumption was particularly intense considering the continued strong population growth; consumption per capita contracted in 2008 as a whole.

	% of GDP (a)		RATE OF CHANGE (b)					
	2000	2008	2003	2004	2005	2006	2007	2008
HOUSEHOLDS AND NPISHs								
Final consumption expenditure	59.7	57.2	2.9	4.2	4.2	3.9	3.5	0.1
<i>Durable consumption</i>	6.3	4.4	6.0	10.7	6.4	4.6	3.9	-10.1
<i>Non-durable consumption</i>	53.4	52.8	2.6	3.6	4.0	3.8	3.4	1.1
Housing	6.1	8.0	9.3	5.9	6.1	6.0	3.8	-10.9
CORPORATIONS								
Private productive investment (c)	16.6	17.6	4.5	6.4	7.4	7.7	5.8	0.5
<i>Construction</i>	4.8	5.8	3.3	11.4	5.7	4.8	2.5	2.1
<i>Equipment</i>	7.3	6.5	3.5	4.3	9.1	10.9	10.2	-1.9
<i>Other products (d)</i>	4.4	5.3	7.2	3.8	7.1	7.1	3.9	1.9
GENERAL GOVERNMENT								
Final consumption expenditure	17.2	19.1	4.8	6.3	5.5	4.6	4.9	5.3
Gross fixed capital formation	3.2	3.8	4.8	-2.6	7.7	7.3	7.3	0.0
<i>Construction</i>	2.3	2.8	3.7	-6.8	7.1	7.8	6.9	-1.6
<i>Equipment</i>	0.8	1.0	8.6	11.0	9.3	5.9	8.3	4.7
MEMORANDUM ITEM								
Gross fixed capital formation	25.8	29.4	5.9	5.1	7.0	7.1	5.3	-3.0
<i>Equipment</i>	8.1	7.5	4.1	5.1	9.2	10.2	10.0	-1.1
— <i>Machinery</i>	5.7	5.3	1.9	3.5	6.9	11.1	11.7	0.8
— <i>Transport</i>	2.4	2.2	9.4	8.7	14.0	8.5	6.5	-5.3
<i>Construction</i>	13.3	16.6	6.2	5.4	6.1	5.9	3.8	-5.3
— <i>Housing</i>	6.1	8.0	9.3	5.9	6.1	6.0	3.8	-10.9
— <i>Other construction</i>	7.2	8.6	3.5	5.0	6.2	5.7	3.9	0.9
<i>Other products (d)</i>	4.4	5.3	7.2	3.8	7.1	7.1	3.9	1.9

SOURCES: INE and Banco de España.

a. National Accounts, base 2000, current prices.

b. National Accounts, base 2000, rates of change of volume indices.

c. Includes investment by sole proprietors.

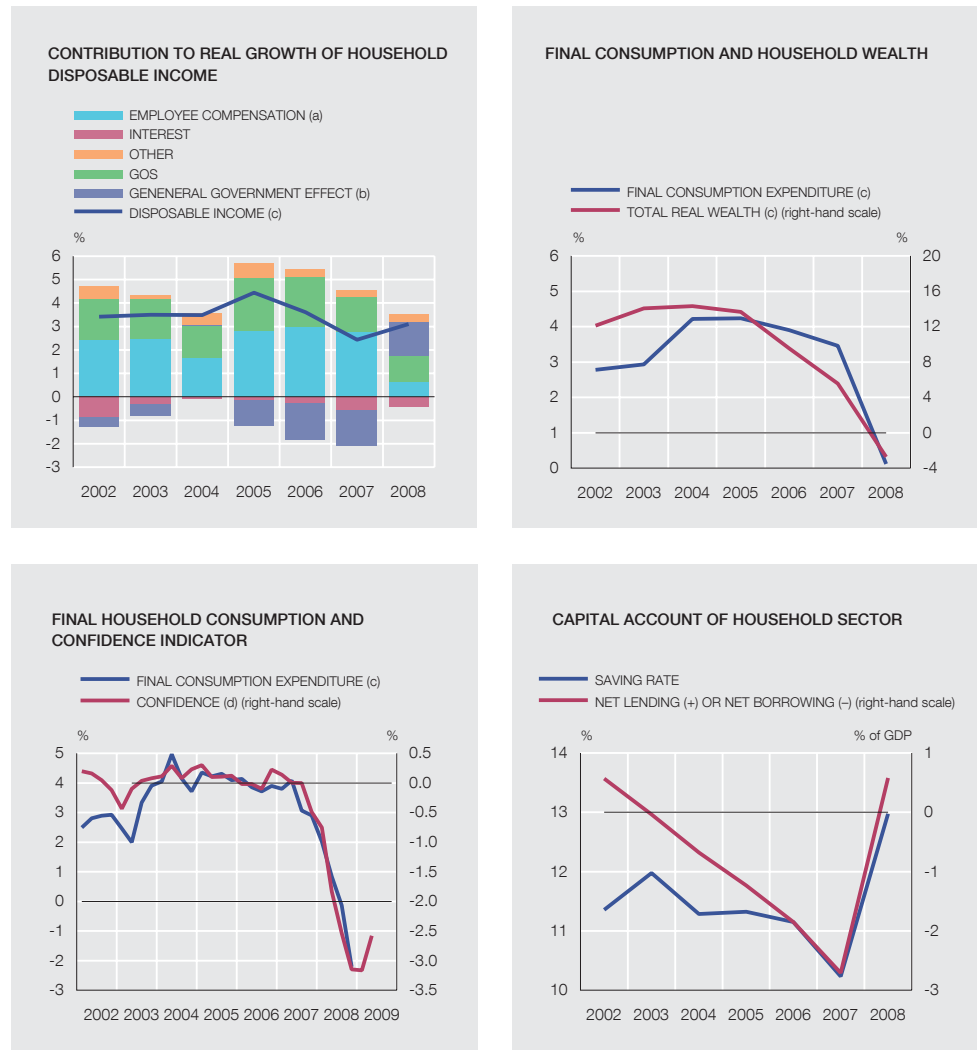
d. This investment includes real estate, legal, accounting, consultancy and software services, among others.

... and a sharp rebound in household saving rates

As spending moderated sharply and disposable income grew, household saving rates rose significantly, by almost 3 pp to 13%, after falling gradually for several years. In this respect, the considerable uncertainty surrounding households' investment decisions has meant that part of the increase in disposable income resulting from the budgetary measures has been saved rather than spent.

The change in expectations regarding house prices, along with tighter credit conditions, drove down residential investment in 2008, ...

The adjustment in residential investment, first seen at the end of 2006, intensified in 2008, as expectations regarding property values worsened, in light of house price developments, and credit conditions tightened. For much of the year, the affordability indicators deteriorated significantly, as a result of interest rate moves and the reduction in typical terms to maturity and in the maximum loan-to-value ratio of mortgage loans, discouraging residential investment, which contracted sharply in 2008, falling by 11% over the year as a whole, but by almost 20% in Q4 (see Chart 5.4). The number of property market transactions also declined sharply: second-hand housing sales, which tend to reflect the market position more accurately and may serve as a leading indicator for future demand for new housing, fell by more than 40% in 2008, while sales of new housing, which could in part reflect purchasing decisions taken in the past, also fell, albeit more moderately (-20%), but with an increasingly negative rate of change as the year progressed.



SOURCES: INE and Banco de España.

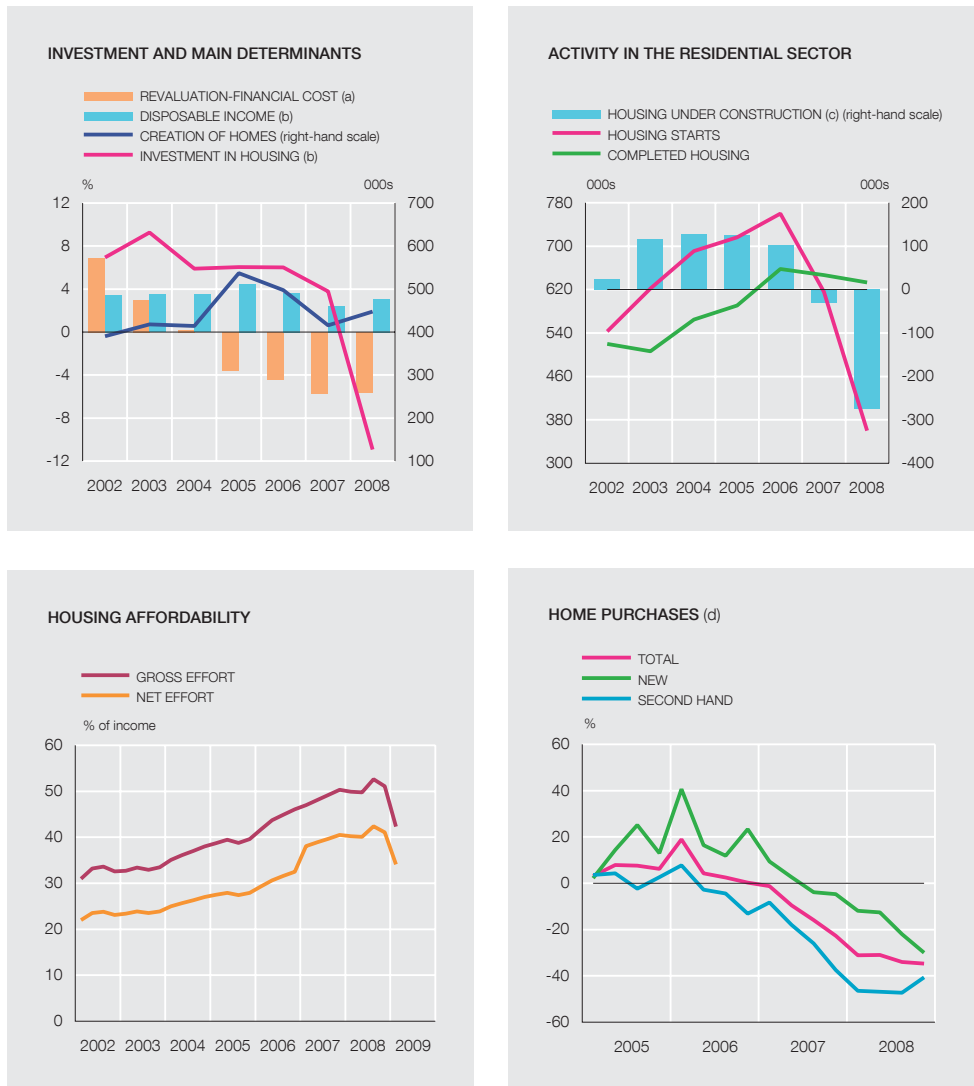
- a. Gross compensation per employee.
- b. Includes social benefits, social contributions and income and wealth taxes.
- c. Rate of change of volume indices.
- d. Normalised data (difference between the series and its mean value divided by its standard deviation).

... resulting in excess supply ...

This intense adjustment in demand was accompanied by a sharp reduction in the number of housing starts: 360,000 in 2008, approximately half the annual average in the period 2004-2007. Nevertheless, the supply of unsold housing grew considerably in the year, as developments begun in the previous growth years were completed. This drove down house prices and may have deterred potential homebuyers, encouraging them to wait until prices stabilise.

... that will gradually be absorbed going forward

The number of housing starts is likely to remain low in the near future, until the stock of unsold properties begins to be absorbed. Accordingly, the decline in residential investment expected in this adjustment phase will be more severe than that seen in other economic cycles in Spain (see Box 1.2). Until the factors that weighed on household spending in 2008 disappear, rapid take-up of the excess supply is unlikely, although there are also several factors that would act in favour, once this occurs. The affordability indicators began to improve significantly at the end of 2008, as both interest rates and house prices fell. Moreover, some of the demographic factors behind the creation of new households in the expansionary phase, which could serve as



SOURCES: INE, Ministerio de Vivienda and Banco de España.

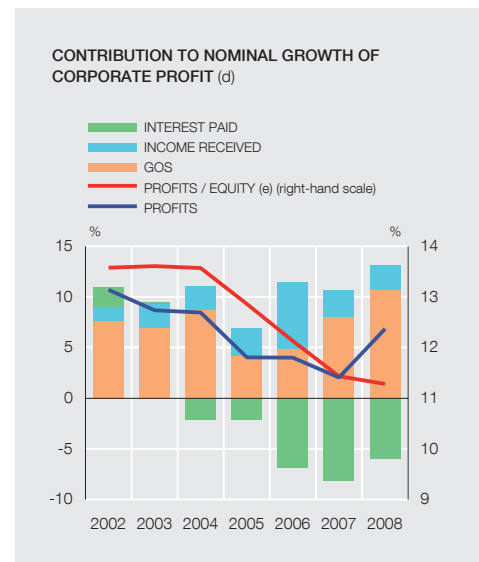
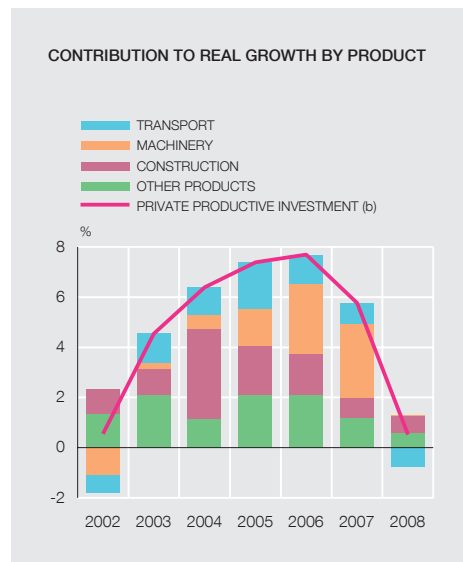
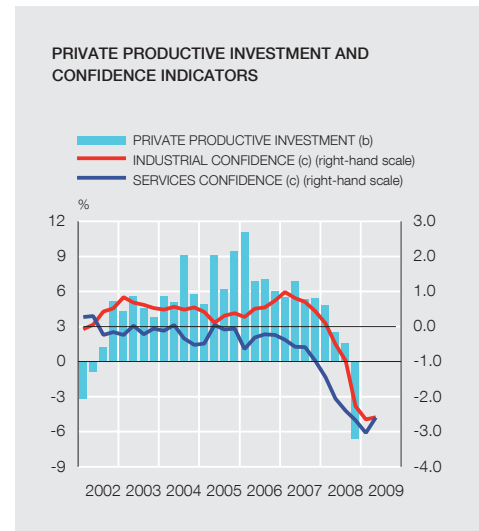
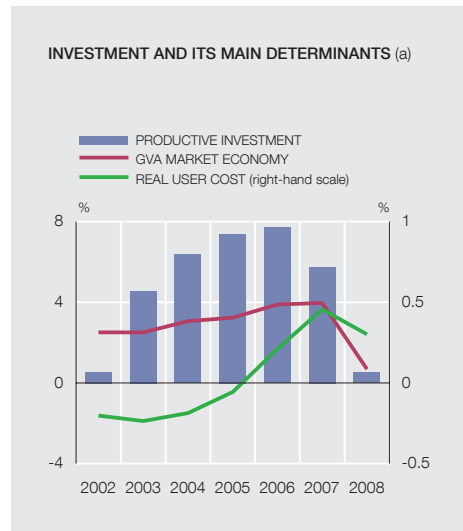
- a. Change in the rate of growth of the price of housing less the change in the interest rate on housing loans. This proxies the change in user cost with the sign reversed.
- b. Real rate of change.
- c. The difference between housing starts and completed housing, which proxies the rate of change in housing stock in construction.
- d. Ministry of Housing real estate transaction statistics. Year-on-year rates of change.

a basis for future potential housing demand, remain present, such as the smaller average size of households, the coming of age of the latest generation of baby boomers and, although to a lesser extent than in the past, the influx of immigrants.

As a result of the decline in residential investment and the increase in the saving rate, households returned to a position of net lending in 2008 (0.6% of GDP), having recorded growing net borrowing since 2003.

General government made a positive contribution to the growth in demand

General government demand remained highly dynamic in 2008, on the back of strong public consumption which rose by 5.3%, almost 0.5 pp higher than in 2007. This rebound was due to the increase in net purchases of goods and services, while compensation per employee continued to grow significantly, at a similar pace to the previous year. By contrast, general government investment in real terms was virtually flat in 2008, for the reasons indicated earlier.

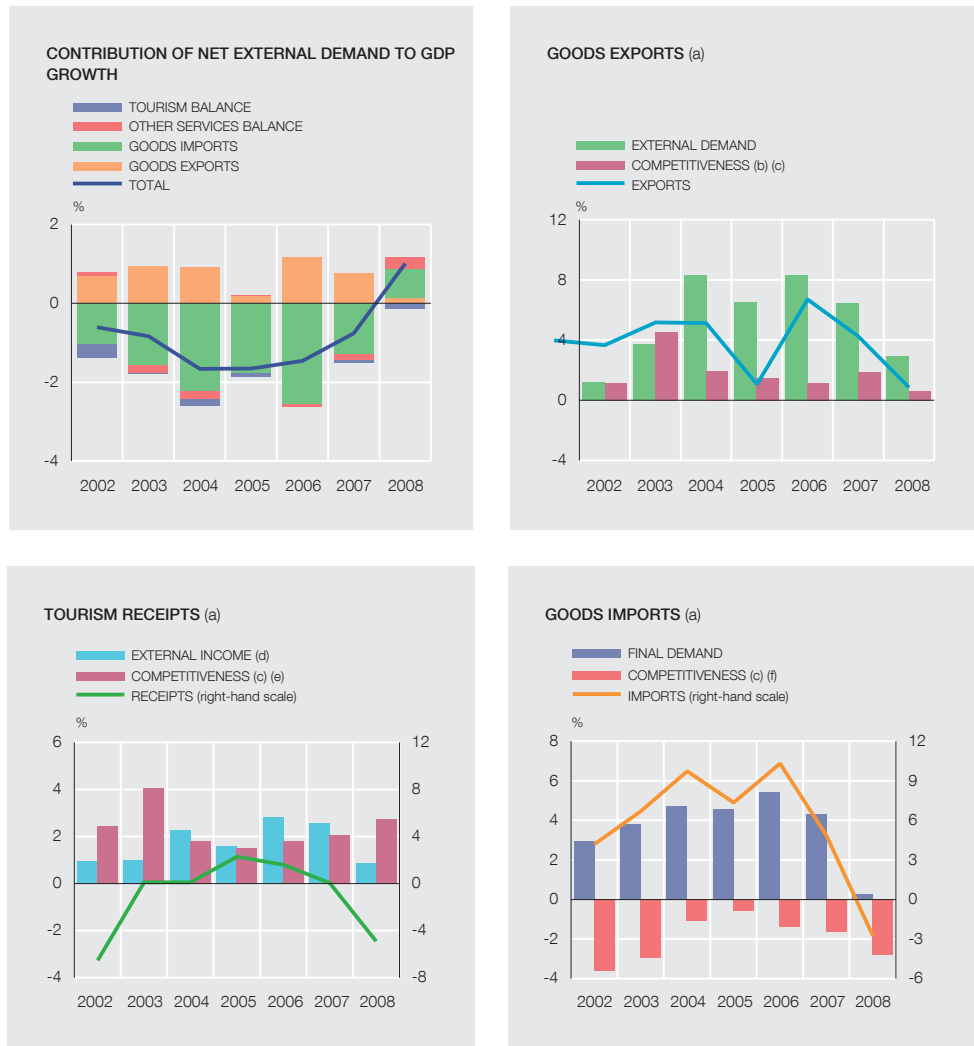


SOURCES: INE and Banco de España.

- a. Real rates of change and changes in the real cost of financing.
- b. Rates of change of volume indices.
- c. Normalised data (difference between the series and its mean value divided by its standard deviation).
- d. Profit is obtained, using National Accounts data, by adding interest and dividends received and other net current transfers to the gross operating surplus, and subtracting interest paid. Thus, the profit in question is after interest and before tax.
- e. Nominal private productive capital stock obtained from the aggregate of private productive investment.

After demonstrating greater resilience in the first half of the year, business investment decelerated sharply towards the end of 2008, ...

Business investment was markedly less dynamic in 2008, posting average growth, in real terms, of 0.5%, as opposed to almost 6% in 2007. Weak (national and external) demand, the increasingly unfavourable economic outlook and harsher external financing conditions for firms were all behind this sluggish performance. On the one hand, as indicated above, the banks began to apply increasingly stricter criteria for approval of new loans, at the same time as the user cost of capital rose in real terms. And on the other, internal financing became more difficult to come by, as the stock market fell and earnings expectations were revised down. The slowdown in investment was particularly significant in 2008 Q4, with a contraction of some 6% on the 2007 close, and it will probably intensify in 2009 since the factors that led to weak business investment in the final stretch of 2008 have remained unchanged to date in 2009.



SOURCES: IMF, OECD, INE and Banco de España.

- a. Real year-on-year rates of change.
- b. Spanish exports deflator in relation to rest-of-the-world export prices, exchange rate-adjusted.
- c. Positive values denote a loss in competitiveness of exports, imports and the Spanish tourism industry, negative values a gain.
- d. Average of GDP growth of the main countries of origin of tourists to Spain, weighted according to the relative significance of the number of visitors.
- e. Real effective exchange rate, measured with consumer prices, vis-à-vis developed countries.
- f. Inverse of producer price index in relation to Spanish imports deflator.

... with a decline in capital goods spending, in particular in transport

All private productive investment components decelerated, but particularly capital goods, which declined by almost 2% (see Table 5.2 and Chart 5.5). Under this heading, the contraction in the transport component was especially noteworthy (5.3% on average in 2008). This was reflected in a slight decline in investment in the services sector, which accounts for 90% of spending on transport, while investment in machinery rose by just 1%, in line with the contraction in industry which accounts for 40% of demand in this segment. Lastly, private investment in non-residential construction decelerated more moderately, sustained by the momentum in infrastructure investment projects undertaken by certain State-owned enterprises, while non-residential building declined significantly, as evidenced by developments in the number of approvals for this type of projects.

High corporate debt and declining returns discouraged investment

The corporate indebtedness ratio remained high and the debt burden rose (see Chart 6.9), discouraging firms from taking on new investment projects. Declining corporate returns, seen in the

profit to productive capital stock ratio (defined using National Accounts variables), which in 2008 continued on the declining path seen since 2004, and in the corporate profits reported to the Central Balance Sheet Office (CBSO), which fell sharply, also acted as a deterrent to investment.

As business investment declined and saving rates rose, firms were able to cut their borrowing

The increase in gross operating profit and, in particular, the sharp decrease in corporate income tax payments, following the latest tax reform, prompted growth in corporate saving in 2008. This, together with the decline in the business investment ratio, led to a significant drop in corporate borrowing, to 7.5% of GDP, as opposed to a high of 11.1% in 2007.

3.2 EXTERNAL DEMAND

External demand made a positive contribution to growth in 2008, for the first time since the end of the 1990s

For the first time since 1997, net external demand made a positive contribution to GDP growth in 2008 (1 pp, as opposed to a negative contribution of -0.8 pp a year earlier). This was due to the notable slowdown, in real terms, in imports of goods and services, which fell by 2.5% (after rising by 6.2% in 2007), as the rate of growth of exports moderated in 2008, rising by 0.7%, in comparison with 4.9% a year earlier.

Goods exports decelerated towards the end of 2008, but over the year as a whole the share in world markets was stable

Goods exports were relatively dynamic, in real terms, in the first three quarters of 2008, but by year-end they had declined considerably, and continued to do so in the opening months of 2009. Spanish exports, which grew by just 0.9% in the year as a whole, as opposed to 4.3% in 2007, thus reflected the impact of the growing weakness of world economic activity in 2008, and its sudden collapse in the last few months of the year. As a result of the globalisation of activity and trade, and in particular of the fragmentation of the production process, trade is playing an increasingly important role in the spread of the present financial and economic crisis (see Box 3.2).

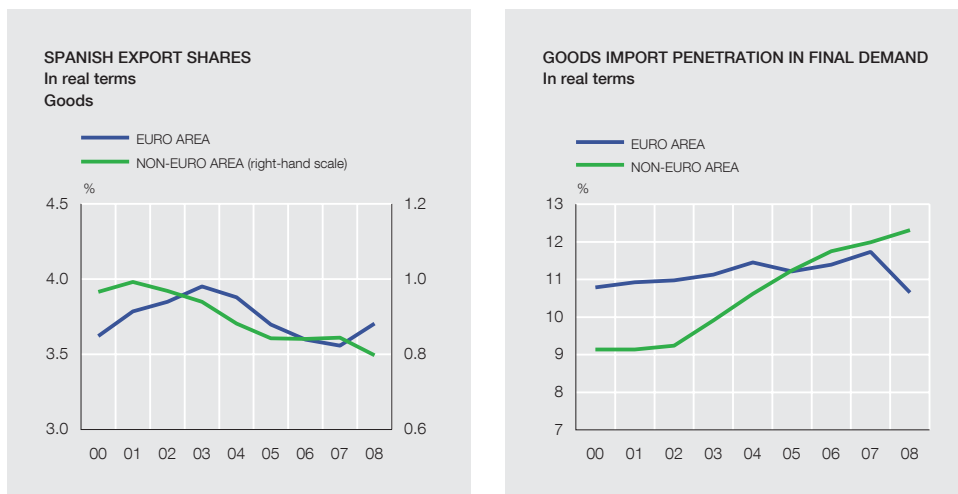
Nevertheless, over the year as a whole, Spain's world export share remained stable, in real terms, for the third consecutive year, as the gains in export share in the euro area offset the loss in share in the rest of the world (see Chart 5.7). The moderate growth in export prices could indicate that export firms, subject to internal cost pressures, may have had to cut their margins once more, in an increasingly competitive environment, so as to maintain their presence on the export markets.

The export slowdown affected almost all products

The breakdown of real exports by product shows that the slowdown was felt across the board, but most particularly in durable goods, which bore the brunt of the contraction in sales of products such as automobiles to the developed countries, and in capital goods, hit by the poor performance of exports of transport equipment. Exports of intermediate industrial products, boosted in 2007 by demand from the emerging economies, moderated considerably in the second half of 2008, consistent with developments in industrial activity worldwide. Lastly, energy exports performed rather better, although they represent only a small proportion of the total, as do highly technologically intensive products (especially, aircraft and pharmaceuticals) which, along with textiles, helped lift exports of non-durable consumer goods.

Services exports also decelerated, although services other than tourism continued to post positive rates of growth

Services exports other than tourism rose by 4.6% in real terms, although this is a lower rate of growth than in the previous two years. In this case also the slowdown was concentrated in the second half of 2008, although it was much less intense than that seen in goods exports. In recent years, services have become more globalised, as technological advances have opened up new marketing possibilities and Spain's big corporations have seized the opportunity to compete in different sectors. According to balance of payments data, construction services, communications, royalties and services provided to companies were the key growth areas in 2008.



SOURCES: IMF, OECD, Eurostat, INE and Ministerio de Economía y Hacienda.

Tourism receipts contracted sharply, against a backdrop of economic uncertainty and euro strength

Tourism receipts fell in 2008 as a whole, but most particularly after the international financial crisis heightened in September. This was part of a worldwide pattern, exacerbated in the case of Spain by the adverse impact of the appreciation of the euro against the dollar and sterling on price competitiveness in comparison with other tourist destinations in the eastern Mediterranean. All this, along with the slowdown in activity in the EU countries, from where most of the tourists coming to Spain originate, brought about a decline of 2.6% in the number of visitors in 2008, in contrast to the growth of 2% in tourist numbers worldwide. Nevertheless, there are signs that the tourists visiting Spain come from an increasingly wide range of countries, and that the minority segments of the tourism market (such as city tourism) which, in addition, attract visitors with higher spending power, are becoming relatively more stable. In the short term, tourist numbers cannot be expected to grow at the same pace as in the past, although this unfavourable outlook for the sector could be mitigated by Spanish nationals choosing to holiday in Spain rather than abroad.

The decline in imports, the first since 1993, intensified as the year progressed, ...

The rate of growth of goods imports moderated as the year progressed, unlike that of exports, although similarly to the case of exports, the fall intensified in Q4 and has continued to do so in 2009. In 2008 as a whole, imports fell, by 2.7% in real terms, for the first time in 15 years, in comparison with growth of 4.8% in 2007, driven down by the loss of momentum in industrial activity and in final demand, which is highly dependent on imports, especially inputs for industry and high-tech capital and consumer goods.

... resulting in a drop in import penetration as a proportion of final demand

The decline in imports was particularly marked in capital goods (in machinery and, above all, in transport equipment), in consumer durables (especially automobiles), and, within industrial intermediate goods, in minerals and products for use in the manufacture of transport equipment. By geographical area, it was concentrated, in real terms, on goods imports from within the EU, which fell by 7.4%, while goods imports from the rest of the world rose by 3.8%, although they too fell in 2008 Q4. Worldwide, trade is declining at a faster pace than activity, and Spain proved no exception to this rule, as the decline in imports exceeded that which was to be expected in light of final demand. Thus, import penetration decreased as a proportion of final demand in 2008, interrupting the continued growth pattern of previous years.

Tourism expenditure fell in 2008, for the first time since 1993

Services imports also fell in 2008, after several years of significant growth. Tourism expenditure declined by 4.5% over the year as a whole, but, similarly to other variables, most intensely in



SOURCES: INE and Banco de España.

a. The output gap, defined as the percentage difference between actual GDP and potential GDP, has been calculated using the NAIRU (the structural rate of unemployment) based on an estimate of the Phillips curve (see the article "Estimates of the potential growth rate of the Spanish economy", by M. Izquierdo and J. Jareño, in *Economic Bulletin*, January 2007, Banco de España).

b. 95% confidence interval considering only the uncertainty in the estimate of the structural component of unemployment.

Q4. High economic uncertainty and the development of the fundamental determinants of tourism expenditure explain the behaviour of this component of household spending, which presents high income elasticity. The decline in imports of other services, which also heightened in the closing months of 2008, was due to royalty payments, insurance, and IT and communications services.

4 Activity

As a result of the sharp slowdown in activity, the output gap narrowed considerably in 2008, although it remained positive

The economic slowdown that had begun in 2007 gradually intensified as the year progressed, gaining in strength as from 2008 Q4. Over the year as a whole, GDP growth, at 1.2%, was short of its potential rate, although this also decelerated, so that the output gap, which had grown throughout the expansionary phase, began to shrink in 2008 (see Chart 5.8).

All areas of activity lost momentum: construction declined sharply ...

The deceleration in the rate of growth of the market economy, down 3.2 pp on the previous year at 0.7%, was much more pronounced than in GDP. By branch of activity, only the energy industry showed greater dynamism in 2008, while value added in agriculture and fisheries declined substantially, with an average rate of growth of -0.6%, 3.6 pp below the 2007 figure.

The fall in production was especially marked in the construction sector (-3.3%), which decelerated sharply in the year, going from positive growth of 1.5% year-on-year in 2008 Q1 to a decline of 8% in Q4. As indicated in the section on national demand, this poor performance was primarily due to housing, while all other building and civil engineering components performed somewhat better. The sharp drop in housing demand, the high stock of unsold properties and the increasing difficulties in accessing financing put a sharp brake on new residential investment projects. Moreover, worsening expectations regarding house prices deterred builders, as the expected returns from new housing supply headed down. Non-residential building also decelerated over the year, as firms reined in their medium-term investment plans in light of the international economic crisis, the deteriorating economic outlook and tightening credit conditions.

... and industry somewhat more moderately, ...

Despite the positive performance of the energy sector, GVA gradually lost momentum in industry and energy in 2008, shrinking at an annual rate of 2%. This was due to the fall in demand for intermediate goods from the construction sector, exacerbated, as the year progressed, by the effect of the decline in consumer goods purchases by households and in capital goods purchases by companies. Moreover, the collapse in international trade in 2008 Q4 prompted a cutback in export goods production. Accordingly, the decline in industrial activity became more pronounced as the year progressed, going from a virtually flat rate of growth year-on-year in Q1 to a negative rate of -4.7% in Q4. This decline was most marked in industries producing goods with lower (especially medium-low) technological content, while more advanced industries posted growth on 2007. In the energy sector, value added rose by around 2%, primarily as a result of greater momentum in gas distribution, while weak electricity demand led to modest growth of scarcely 1% in electricity generation.

... while market services, although recording positive growth, decelerated significantly in the year

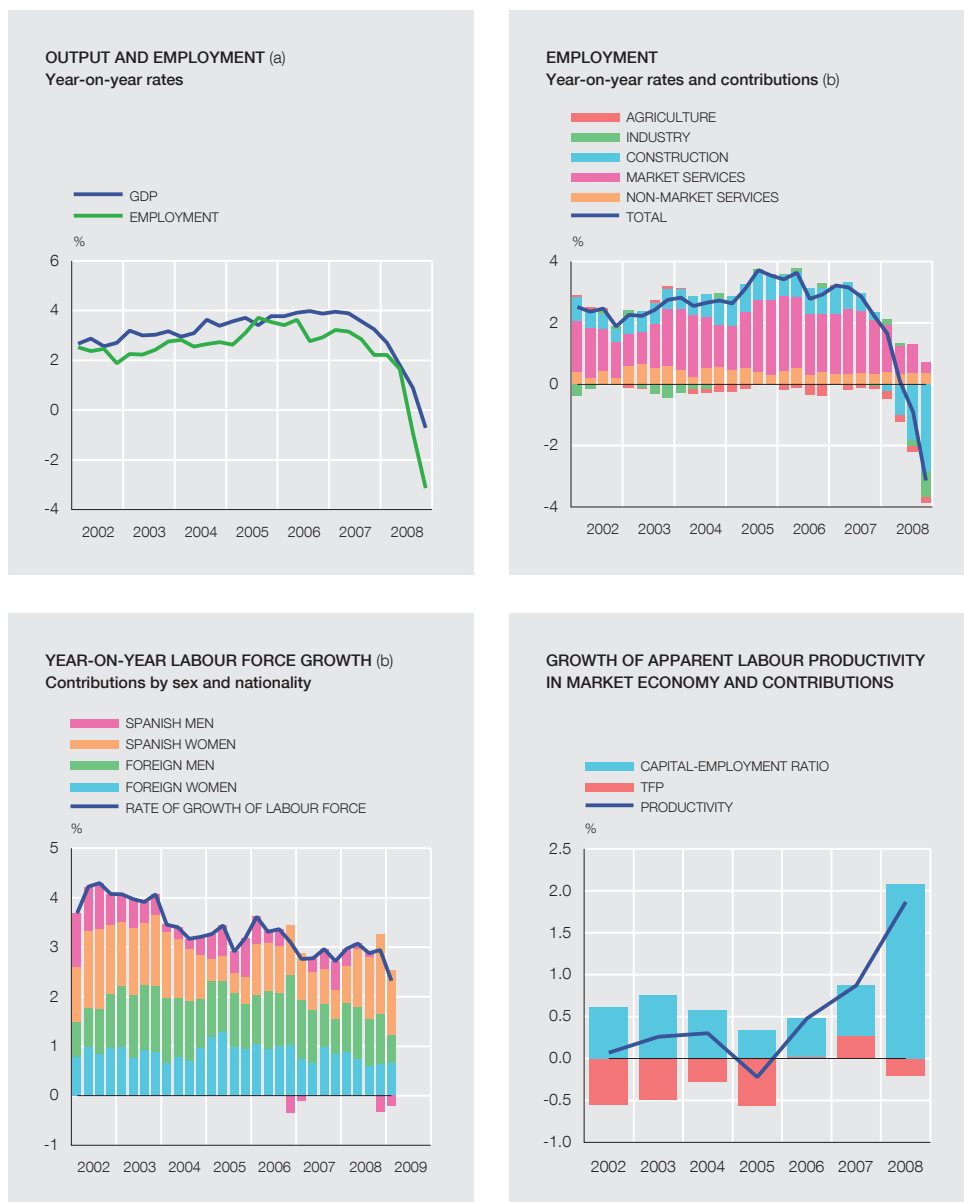
Activity in the services sector as a whole decelerated sharply in 2008, growing at an average rate of 3.1%, on the back of the progressive deterioration in market services, whose GVA grew by 2.6% in the year (0.7% in Q4), as opposed to growth in excess of 4% in the three previous years. This loss of momentum was seen across the board, both in domestic market and export services, but most particularly in services connected with the automobile and tourism industries and in business services.

5 The labour market

Jobs were destroyed in 2008, after a lengthy period of strong employment growth

After 14 consecutive years of employment growth, at an annual average rate in excess of 3%, in 2008 employment fell by 0.6%, although the labour market deteriorated much more severely in the second half of the year, shrinking at a rate of 3.1% in year-on-year terms in Q4 (see Chart 5.9). The decline was worse in the market economy, where employment fell by 1.2% on average in the year.

The adjustment in employment was much higher than that seen in economic activity due, among other factors analysed in Chapter 2 of this Report, to wages which rebounded sharply, both in nominal and real terms. The rate of growth of apparent labour productivity stood at 1.8% although, as shown in the bottom-right panel in Chart 5.9, which presents an estimated breakdown, this increase was due to the sharp fall in employment, which lifted the capital-employment ratio, with no gains visible in estimated total factor productivity.



SOURCES: INE and Banco de España.

a. Seasonally-adjusted QNA series. Full-time equivalent employment.
b. The EPA (Spanish Labour Force Survey) series are linked on the basis of the 2005 Q1 control survey.

By branch of activity, the deterioration, although generalised, was particularly notable in construction

Construction bore the brunt of the adjustment: employment fell by slightly more than 10% over the year as a whole, with negative rates of change as from Q1 and a decline of more than 20% in Q4. In industry, despite the recovery seen in the first part of the year, employment fell by 1.2%, with extensive job destruction in Q4. In market services, employment rose by 1.9%, less than half the rate of growth seen in 2007, and with virtually flat growth by year-end. Lastly, in agriculture, jobs were destroyed again, for the sixth consecutive year, and at a higher rate than in 2007. Nevertheless, non-market services offset part of this adverse performance, growing at a steady rate of 2% throughout the year, very similar to the previous year.

The strong growth in productivity in the construction sector (8.3%) explains the bulk of the rebound in productivity in the economy overall, after a long period of decline. Productivity

growth was more modest in services and was even negative in industry, falling sharply in the first half of the year.

The decline in employment brought about a reduction in the ratio of temporary to total employees.

The employment breakdown based on contract duration shows that employees with temporary contracts bore the brunt of job destruction, as their numbers fell by 8% in the year and by more than 12% in Q4. The number of employees with permanent contracts rose by 3%, although this rate of growth slowed markedly in the year and was virtually flat at end-2008. The ratio of temporary to total employees thus stood at 29.3%, more than 2 pp below the 2007 figure. This decline is primarily due to the cyclical pattern of temporary employment, which has borne the brunt of the adjustment. Thus, for example, on EPA (Spanish Labour Force Survey) data, 14.5% of employees with temporary contracts in 2008 Q3 were unemployed three months later, in comparison with 2% of employees with permanent contracts. Job destruction in the construction sector, where the proportion of temporary to total employees is very high and a third of workers with temporary contracts lost their jobs in the year, also contributed to this decline. Hirings of foreign workers continued to increase in 2008; however, the rate of growth was much lower than in 2007, and fell sharply as the year progressed, becoming virtually flat in 2008 Q4.

Despite the deterioration of the labour market, the rate of growth of the labour force quickened in 2008

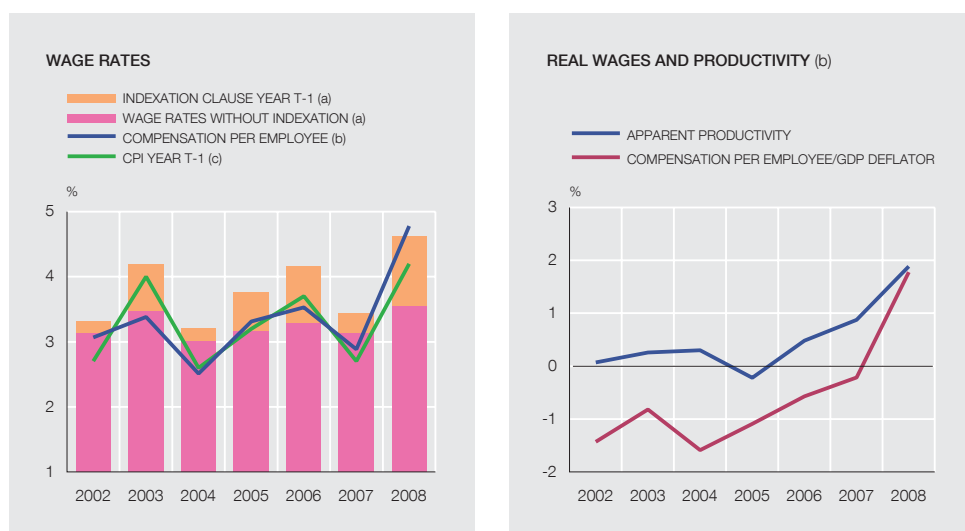
The labour force regained a certain degree of momentum, growing by 3% in the year, although the rate of population growth moderated, from 1.8% in 2007 to 1.4% in 2008. This lower rate of growth was due to the slowdown in net migrant inflows, which although still high (some 450,000 persons over 16 years of age), reflected some reaction to the deterioration in activity. Accordingly, the rebound in the labour force was due to the higher rise in the participation rate, which at 59.8% was up 0.9 pp on 2007 and in line with the growth seen in the years of strong job creation. This is due, primarily, to the growing numbers of Spanish women joining the labour market, whose participation rate rose by 1.4 pp (as opposed to 0.9 pp in 2007), partly as a reaction to growing unemployment among other groups (in fact the participation rate rose among women whose husbands were unemployed). After declining in 2007, the participation rate among foreign nationals regained the momentum of previous years, rebounding by almost 1 pp, primarily as a result of the female segment.

The severity of the employment adjustment and the growth in the labour force led to a sharp rise in unemployment

Unemployment rose by more than 1.2 million (66.4%) in 2008, closing the year at more than 3.2 million, with an unemployment rate of 13.9%, in sharp contrast to the all-time low of 8% a year earlier. The increase in unemployment was particularly marked among younger and less-skilled workers, and among foreign workers whose unemployment rate rose by some 5 pp to 17.5%. This sharp rise in unemployment continued in 2009 Q1; at end-March the unemployment rate stood at 17.4%, with the jobless total in excess of four million. The estimates available on the structural component of unemployment point to a more moderate increase in NAIRU than in the unemployment rate in 2008. For 2009, however, a bigger increase in structural unemployment, associated with a significant rise in long-term unemployment, cannot be ruled out.

Wages rebounded both in nominal and real terms in 2008, showing scant sensitivity to the worsening economic climate

Wage increases under collective bargaining agreements stood at 3.6% in 2008, 0.5 pp above the increase agreed for 2007, despite the progressive deterioration in the labour market in the year (see Chart 5.10). Nevertheless, wage rates mainly reflected the poor inflation performance in the first half of the year, but with no sign of a turndown in the new agreements signed in the closing months of the year, when inflation had begun to moderate and the labour market situation was significantly worse. Moreover, as inflation missed the 2% target set for end-2007 (by 2.2 pp), the indexation clauses were activated, thus increasing wage pressure, with an impact of 1.1 pp on wages paid in 2008.



SOURCES: INE and Ministerio de Trabajo y Asuntos Sociales.

- a. Information on collective bargaining agreements recorded to April 2009.
 b. Market economy.
 c. Year-on-year rate of change in December.

These developments in collective bargaining agreements were reflected in QNA estimates of compensation per employee, which showed wage costs rebounding to 4.8% in the market economy, the biggest increase since the early 1990s. This represents virtually flat wage drift² in 2008, in the wake of the negative figures of previous years, related to the disappearance of the composition effects that were behind this negative wage drift. In real terms, labour costs borne by firms, using the GDP deflator of the market economy as a price index, rebounded sharply in 2008 (see Chart 5.10), closing the gap with labour productivity seen in previous years.

6 Prices and costs

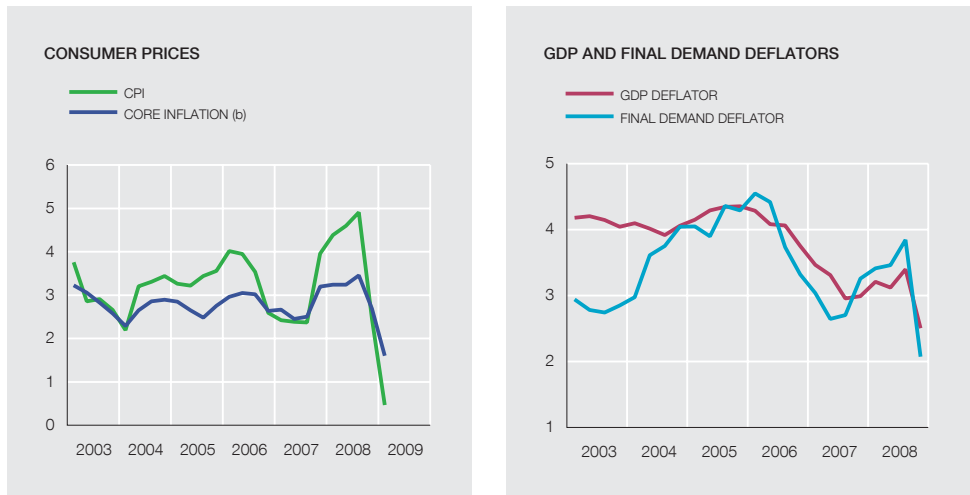
Inflation declined sharply as from mid-2008; this process has intensified in 2009 to date, with negative rates of change year-on-year

Inflation in 2008 reflected the fluctuations in the price of oil, ...

For the consumer price index (CPI), 2008 was a year of two very distinct halves. In the first half of the year, inflation rose significantly, continuing in the pattern seen since the summer of 2007, reaching 5.3% in July. It then headed down even more pronouncedly, closing the year at 1.4%. This decline has continued in 2009 to date, so that by end-March the year-on-year rate of growth was negative at -0.1%, the lowest rate of inflation since 1952. Two key factors in this decline were the decreases in energy and food commodity prices, against a backdrop of extreme economic weakness worldwide, and the decline in national, especially household, spending. This meant that companies had to adjust their prices, cutting their margins or searching for productivity gains to offset the impact of labour costs. Moreover, the effects of the shocks were more intense in Spain than in the euro area, so that the inflation differential (measured with the HICP), which had remained on average at around 1 pp since 1999, narrowed significantly as from 2008 Q4. Since December it has been increasingly negative, standing at -0.7 pp at March 2009, the lowest level since the start of monetary union.

Inflation measured by the CPI rose by 1.3 pp over the year as a whole to 4.1%, the result, as indicated above, of two very different half-year periods. In the first half of the year, the price of crude oil on the international markets rose substantially: the price of Brent oil verged on \$150 per barrel in July, an all-time high in nominal terms. It headed down thereafter, closing the year at slightly more than \$40 per barrel, and has then rebounded somewhat in 2009 to date. The

2. Defined as the difference between the increase in wage settlements under collective bargaining, including the effect of the indexation clauses, and the increase in compensation per employee in QNA.



SOURCES: INE and Banco de España.

- a. Year-on-year growth rates.
- b. General index, excluding unprocessed food and energy prices.

euro exchange rate against the dollar, which appreciated when the price of oil rose and depreciated when it fell, cushioned, to a certain extent, these fluctuations in the oil price when measured in euros. In comparison with the euro area, the higher spending on oil derivatives as a proportion of total household spending in Spain, and the lesser weight of excise duties on these products, mean that fluctuations in the oil price have a greater impact on prices in Spain than in the euro area. That explains, in part, the narrowing of the inflation differential with the euro area described above. The pass-through of oil price fluctuations to the prices of non-energy products was moderate (in line with the econometric estimates available), although the rising prices of energy products, which helped keep inflation rates high in the first half of 2008, are partly responsible for the rebound in wage settlements in the year.

... food prices ...

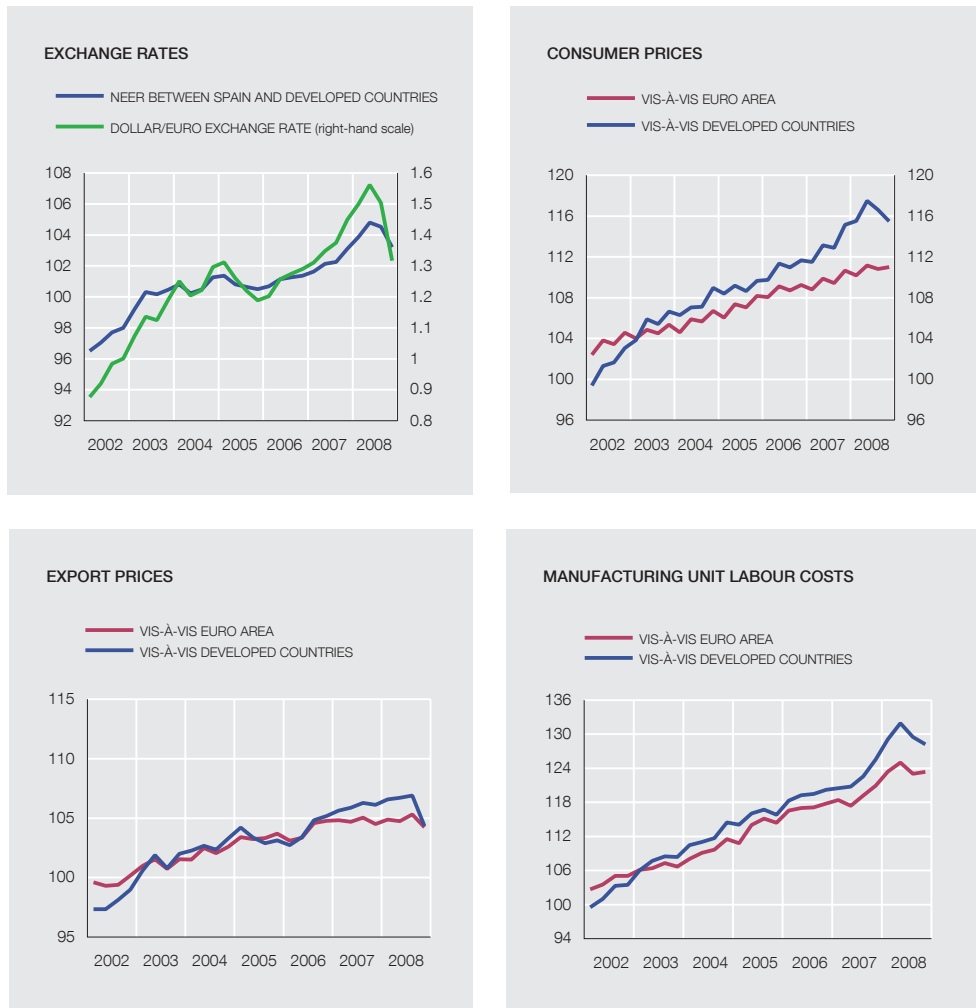
Inflation likewise reflects prices of foodstuffs, which rose on the international markets in 2007, prompting an increase in crop-growing worldwide. This, accompanied by generally favourable weather conditions, boosted global production and stock levels. In this setting, food commodity prices on the international markets have fallen substantially, especially since mid-2008, helping rein in the rate of growth of consumer food prices in Spain and, to a lesser extent, in the euro area.

... and the impact of recession

In 2008 as a whole, services prices rose at a rate of 3.9%, very similar to that of previous years. However, these prices decelerated in the final stretch of 2008 and have continued to do so in 2009 to date, pointing to an adjustment in prices and margins to the decline in household spending. Accordingly, by March 2009, the rate of growth of services prices had dropped to 2.7%, narrowing the attendant differential with the euro area. The rate of increase of prices of non-energy industrial goods declined on average in 2008 to 0.3%, 0.4 pp below the 2007 figure. In 2009 the rate of change has decelerated even further, to -0.6% in March, substantially below the rate for the euro area. This intense price adjustment seems to be due to the contraction in demand, and possibly to the high competitive pressure in some markets (such as clothing and footwear) stemming from the growing weight of the new producer countries.

The GDP deflator decelerated in 2008, especially in the second half of the year

The GDP deflator rose by 3% in 2008, 2 pp below the previous year's rate. The slowdown was most intense in the second half of the year, bringing the rate of change to 2.5% in 2008 Q4. All demand components decelerated in the final stretch of the year, in contrast to the more disparate earlier performance. Specifically, inflationary pressure in the commodities markets in



SOURCE: Banco de España.

a. An increase in the index denotes a loss of competitiveness, and vice versa.

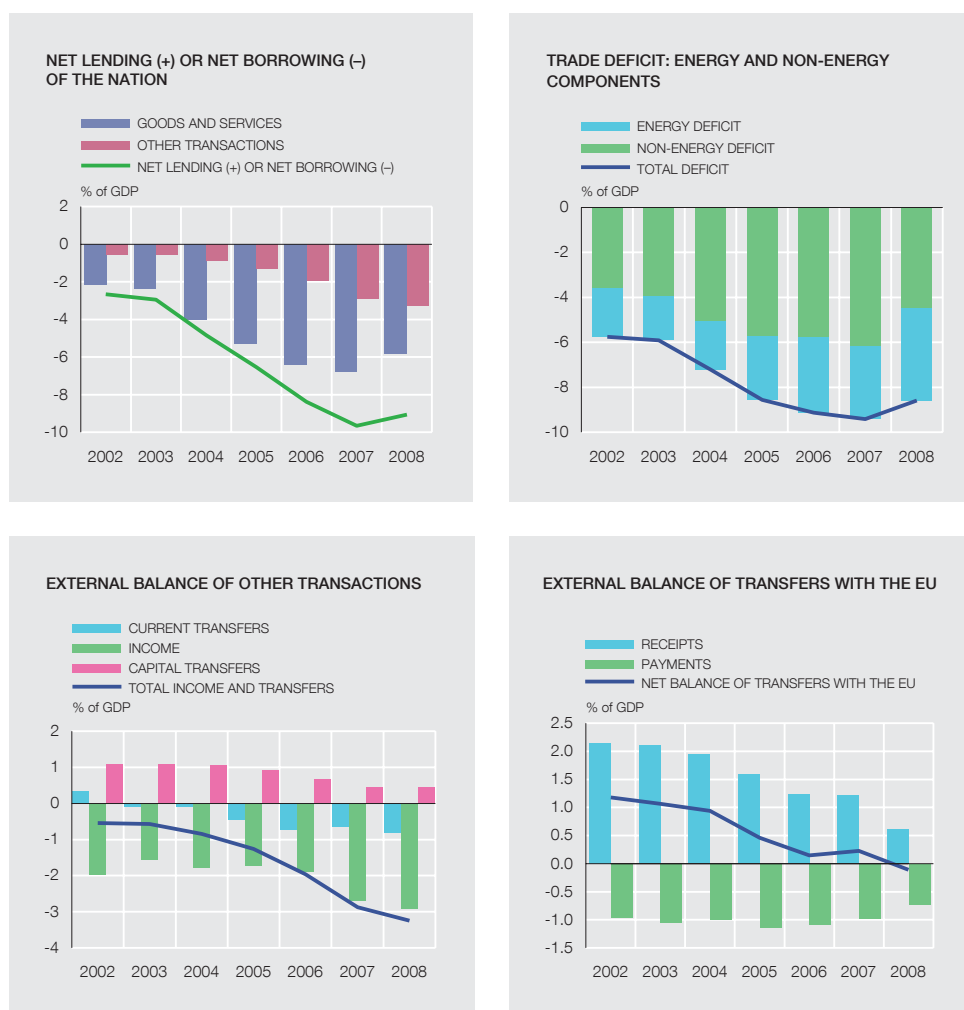
the first quarters was clearly discernible in the import and consumption deflators. The export deflator also rebounded in the first half of 2008. By contrast, the gross capital formation deflator decelerated throughout the year, due, above all, to residential investment which reflected developments in house prices.

Unit labour costs rebounded, as wages rose significantly, ...

Despite the severe deterioration in the economic conditions, the rebound in compensation per employee exceeded the increase in apparent labour productivity, so that labour costs per unit of value added in the market economy accelerated.

... prompting a loss of price-competitiveness in 2008 as a whole, although this reversed in part in the second half of the year

The different price-competitiveness indices vis-à-vis the main developed countries continued to deteriorate in the year as a whole, although the depreciation of the euro and the generalised correction in price differentials prompted some degree of improvement as from the second half of the year. Vis-à-vis the euro area, the price-competitiveness indicators were similar, in general, to the previous year's, with the exception of those based on unit labour costs in manufacturing, which deteriorated, and those based on export prices, which improved markedly. By contrast, outside the euro area, the losses in price competitiveness were higher than in 2007, since the narrowing of price and cost differentials, which in some cases became negative, was more than offset by the appreciation of the euro in the year as a whole (see Chart 5.12).



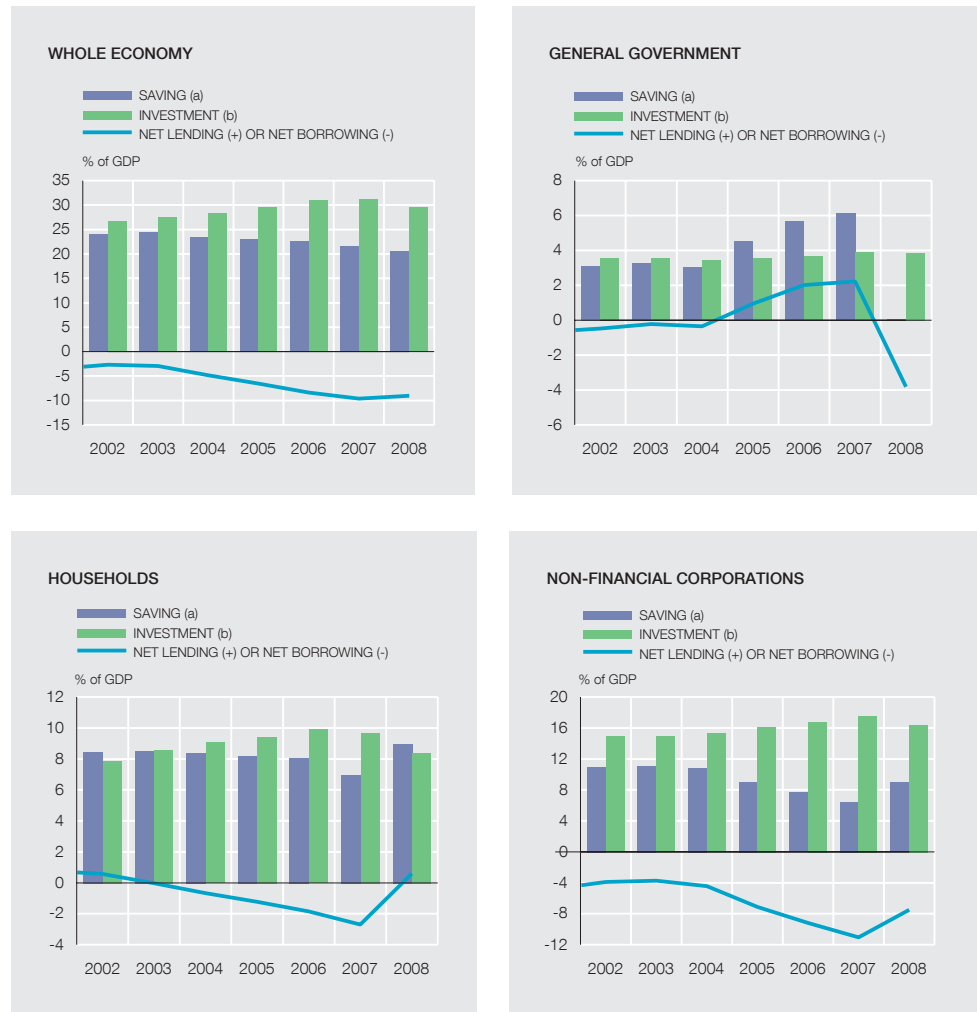
SOURCES: INE, Departamento de Aduanas and Banco de España.

7 Net borrowing of the nation and the capital account of the institutional sectors

The nation's net borrowing fell, for the first time since 2002

As Spanish economic growth decelerated, net borrowing moderated, posting negative rates of change year-on-year in the second half of 2008 and in 2009 to date. The decline in the external deficit has been strengthened in recent months by the severity of the contraction in national demand, which drives down imports, and by the falling price of energy, which has led to a substantial reduction in the energy deficit.

Over the year as a whole, the nation's net borrowing fell to 9.1% of GDP, 0.6 pp below the previous year's figure, interrupting a persistent upward pattern. As indicated above, the correction became more intense as the year progressed: thus, net borrowing in 2008 Q4 represented 2 pp of GDP, below the figure a year earlier, while the trade deficit was more than 3 pp below the 2007 Q4 figure. Returning to the total for the year, the improvement in the external balance reflects the decline in the current account deficit, to 9.5% of GDP, as the surplus on capital transactions held steady at around 0.5% of GDP (see Chart 5.13). In the year as a whole, the decline in the trade deficit (0.8 pp to 7.7% of GDP) offset the deterioration in the investment income balance and, to a lesser extent, in the current transfers balance. By geographical area, the correction focused on trade with the EU, as the deficit with the non-Community countries continued to grow, primarily reflecting the impact of the rebound in average annual commodity prices.



SOURCES: INE and Banco de España.

- a. Gross national saving.
- b. Gross capital formation.

The tourism surplus continued to decline in 2008

As in the previous year, the tourism surplus continued to decline as a percentage of GDP in 2008, although in this case tourism receipts and expenditure headed down, most notably in Q4. Non-tourism services continued to post positive growth rates in the year as a whole, but they also decelerated considerably as the year progressed, especially imports, prompting a correction of almost 0.3 pp in the attendant deficit, to 0.9% of GDP.

The income deficit continued to grow, ...

The international financial crisis made access to international financing more difficult, especially on the capital markets. As a result, interest rates on funds raised abroad by the banks rose and there was a shift away from long-term issues and towards short-term instruments, including, notably, an increase in resource to the Eurosystem. In this setting, although the external debt of the Spanish economy remained at the high levels seen in 2007 (around 80% of GDP), the investment income deficit as a proportion of GDP widened by 0.2 pp to 2.9%, reflecting the increase in the negative balance associated with portfolio and other investment income, which the increase in the surplus on direct investment income failed to offset.

The nation's net borrowing stood at 9.1% of GDP at end-2008, signifying an interruption in the growth pattern of recent years (see Panel 1). Although this correction amounted to only 0.6 pp of GDP over the year as a whole, it was more significant in H2, with a decline of 2 pp of GDP in Q4, and all the indications are that this decline intensified in the opening months of 2009. Moreover, this aggregate economic performance conceals important changes in the imbalances between saving and investment in each of the institutional sectors. Thus, after five years of net borrowing, households returned to a position of net lending (0.6% of GDP), and net borrowing by non-financial corporations fell by more than 3.5 pp of GDP to 7.5%. However, while the private-sector balances improved, the imbalance between general government saving and investment deteriorated significantly, going from net lending in the period 2005-2007 to net borrowing of 3.8% of GDP.

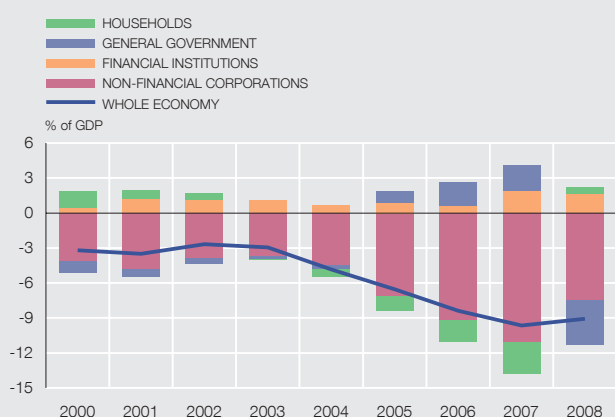
These changes came about against a backdrop of declining saving and investment rates, based on relatively different contributions from the different economic sectors. Thus, the major slowdown in business investment and the sharp adjustment in residential construction in 2008 gave rise to a decline in investment by households and non-financial corporations. This passed through to total gross capital for-

mation, which declined as a proportion of GDP for the first time in the last decade (see Panel 2). However, general government gross capital formation continued to represent 3.9% of GDP, which is relatively high in comparison with other European countries.

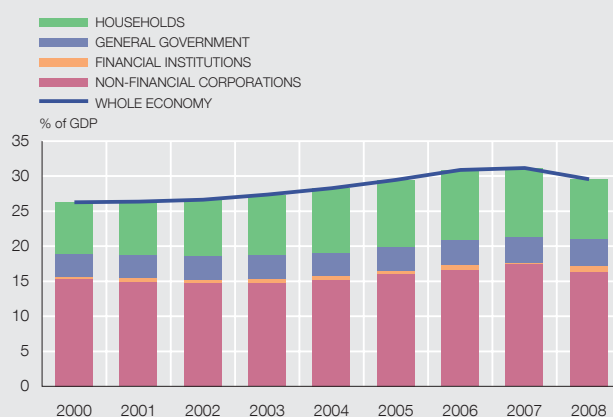
National saving continued to decline in 2008, in line with the negative growth pattern of recent years (see Panel 3). Nevertheless, the breakdown by sector shows significant changes in comparison with previous years. The household saving rate, which had gradually dropped to 10.2% of gross disposable income by 2007, rose to 13% at end-2008, resulting in an increase of 2 pp as a percentage of GDP. Likewise non-financial corporations' saving, which also rose by 2 pp of GDP, after declining in the previous three years, due, above all, to the increase in debt servicing payments. By contrast, general government saving fell sharply (by more than 5.5 pp of GDP), more than offsetting the growth in private-sector saving.

These figures reflect some correction in households' and non-financial corporations' net borrowing positions in 2008, although this was due, in part, to a transfer of funds from the public to the private sector. Among the possible channels for this transfer of funds (taxes, transfers, social contributions and benefits), the role of the automatic

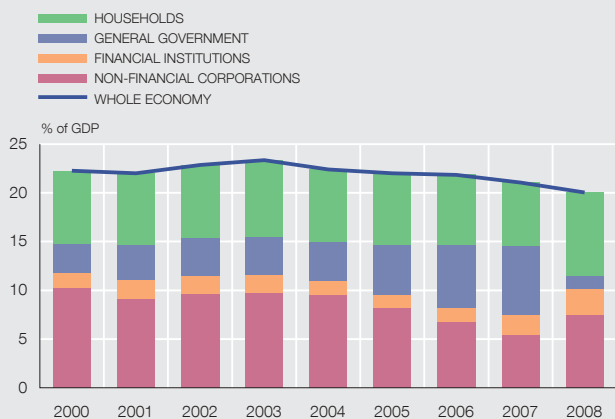
1 NET LENDING (+) OR NET BORROWING (-) OF THE NATION



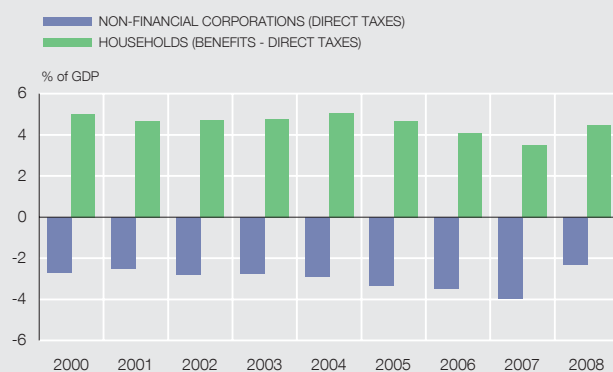
2 GROSS CAPITAL FORMATION



3 GROSS NATIONAL SAVING



4 IMPACT OF DIRECT TAXES AND BENEFITS ON HOUSEHOLD AND CORPORATE INCOME



SOURCE: INE.

stabilisers and of the expansionary fiscal measures adopted are particularly noteworthy. In this respect, the institutional sectors' accounts show that increased social benefits and lower direct tax payments raised households' disposable income by 1 pp of GDP in 2008 (see Panel 4). In the case of non-financial corporations, lower corporate income tax payments, due not only to regulatory amendments made before the onset of the financial crisis (such as the second part of the lower corporate income tax charge) but also to the decline in corporate earnings growth, signified an increase in income equivalent to 1.7% of GDP. There were no significant changes in the effect of social contributions on agents' income in 2008, as these were stable as a percentage of GDP.

In short, the institutional sectors' accounts show that household and corporate imbalances began to adjust in 2008, as investment declined and saving rates rose. The adverse impact on activity was cushioned by the behaviour of general government, which helped sustain disposable income in the private sector. The decline in the nation's net borrowing, which can be expected to continue through 2009 and 2010, had a balancing effect on this process. The latest Banco de España macroeconomic projections point to a decline in net borrowing up to 2010 of some 5 pp of GDP, due, as in 2008, to an adjustment in households' and non-financial corporations' spending, while it is estimated that the budget deficit will continue to grow throughout the projection period.

... as did the current transfers deficit, as the balance with the EU deteriorated, in contrast to the relative stability of the surplus on capital transactions

The deficit on net current transfers stood at 0.8% of GDP in 2008, an increase of 0.2 pp in 2007, as expenditure rose moderately and receipts declined. The fall-off in migrants' remittances, in the wake of the sharp growth seen since the beginning of the decade, was more than offset by the increase in general government expenditure, related to the EU and to donations. For its part, the decline in receipts reflects the decrease in Community funds. The surplus on capital transactions was steady as a percentage of GDP at 0.5%, interrupting the declining path of previous years. Capital transfer receipts from the EU rose slightly, in contrast to 2007. Overall, the positive balance on the general government's current and capital transactions with the EU fell significantly in 2008.

Net borrowing declined, especially in the private sector, as the public-sector balance deteriorated considerably

The decrease in net borrowing in the Spanish economy in 2008 was due to the decline in investment (down 1.7 pp of GDP to 29.6%), as the gross national saving rate continued to fall (by 1.1 pp of GDP to 20.5%) (see Chart 5.14). The aggregate pattern was due to a very disparate performance by the public and private sectors. Thus in 2008, for the first time since 2003, households recorded moderate net lending, as a result of the decline in residential investment and the substantial recovery in the saving rate, connected, to a certain extent, to the considerable fiscal stimulus applied (see Box 5.2). At the same time, net borrowing by non-financial corporations fell in the year, as business investment moderated as the year progressed. By contrast, in the public sector, general government net borrowing rose in 2008, with a deficit of 3.8% of GDP, in comparison with the surplus of 2.2% of GDP a year earlier, reflecting the impact of the economic crisis and of the various expansionary measures approved in the year. The developments described for the different institutional sectors will foreseeably continue in 2009, with a more substantial correction in the nation's net borrowing, as increased net lending by households and non-financial corporations should outpace the growth of the budget deficit.